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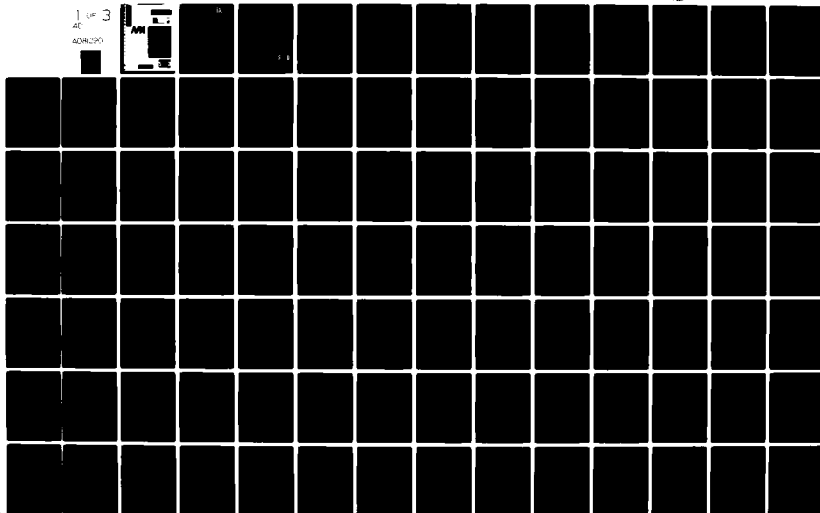
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PROSPECTIVE DEVELOPMENTS IN WESTERN EUROPE

AND IN THE NORTHWEST INDIAN-OCEAN REGION.

A Study of Selected Mid-Term Problems in
U.S. Foreign Policy,
Prepared for the Department of State

by

Theodore Geiger

with an Appendix by Robert A. Dennis

Robert Kramer, Research Assistant

February 1975

NATIONAL PLANNING ASSOCIATION
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FOREWORD

This study deals with the problems likely to confront the United States during the remainder of the 1970s in two regions in which the United States has vital interests: Western Europe, and the group of nations bordering on the northwest Indian Ocean and its major extensions, the Red Sea and the Persian Gulf. An introductory chapter analyzing the changing nature of the international political and economic system in the current period is followed by two chapters each covering one of these regions. All three chapters employ a common conceptual framework and consistent analytical approach, but each is self-contained and can be read apart from the others.

The conceptual framework and analytical approach are interdisciplinary and systemic. Indeed, they are not simply interdisciplinary in the conventional sense of the term, that is, taking account of separate political, economic, psychological, and other relevant factors. Instead, an attempt is made, within the limited time and space available, to integrate the analysis of interacting factors into a truly sociological approach, in the basic meaning of that term. For this reason, the key sociological concepts consistently used throughout the study need to be explicitly defined. All social systems have two inseparable and mutually determining aspects -- the institutional aspect and the cultural aspect. By the institutional aspect is meant the specific organizations, groups and other persisting patterns of relationships among the people comprising the society. By the cultural aspect is meant their distinctive modes of feeling, seeing, believing, thinking, and acting that are rooted

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in psychological processes and expressed in interpersonal relations, institutional patterns and material, aesthetic and intellectual productions. Neither aspect can exist without the other, and each is constantly reshaping itself and the other in a multiplicity of continuous interactions that are manifested in rapid change in certain periods and kinds of societies and in slow -- in some cases imperceptible -- modifications in others.

The data, analyses and conclusions presented in this study are the responsibility of the author and do not necessarily represent the views of the Department of State or the National Planning Association. Robert A. Dennis, Acting Director of NPA's National Economic Projections, is responsible for the Appendix sketching the economic outlook for the OECD countries. Robert Kramer, Research Assistant at NPA, provided data for Chapter III and contributed some of the ideas for and first drafts of portions of that chapter. A great debt is owed to Olga Bilyk for her conscientious and cheerful performance of the stenographic and administrative tasks required. As always, the perceptive suggestions and careful editing of Frances M. Geiger have importantly contributed to such merit as this study may possess.

February, 1975

Theodore Geiger
Director of International Studies
National Planning Association

SUMMARY

The main points made in the three chapters of the study are sketched in this Summary. Because it perforce omits much of the analysis, explanations for the interpretations and projections presented in the Summary can only be found in the study itself.

Chapter I - The Nature of the International System During the Remainder of the 1970s

Two periods can be distinguished in the evolution of the international system since World War II: the postwar period of system reconstruction covering roughly the two decades from the mid-1940s to the mid-1960s; and the current period of the new nationalism that began in the mid-1960s and is likely to continue for the foreseeable future.

The postwar period was dominated by the cold-war competition of the two superpowers, the United States and the Soviet Union, as each sought to realize its own design for a reconstructed world order. Each organized a network of alliances, over which it exercised hegemonic control; in addition, the two superpowers competed for influence over the new nations of Asia and Africa, then in process of becoming independent, through economic and military assistance and in other ways.

In the noncommunist part of the international system, over which the United States had a greater or lesser degree of determinative influence, the postwar period was marked by increasing international economic integration as the West European nations recovered from wartime disruption and enjoyed rapid rates of economic growth, and the countries of Asia, Africa and Latin America initiated continuing efforts to accelerate their economic

development. At the same time, the West European nations launched the movement toward economic and political unification that culminated in the establishment of the European Community.

In the course of the 1960s, however, far-reaching changes in the structure of the international system and in the behavior of the nations involved became increasingly evident. These developments reflected the completion of postwar reconstruction and the subsequent high economic-growth rates in Western Europe and Japan, the great decolonization movement that brought 70-odd new nations into existence, and the socio-cultural changes within the various kinds of countries comprising the international system.

Although there are important differences among them, all of the developed nations of North America, Western Europe and the Pacific have been experiencing mounting demands on the part of their people for rising living standards, improved quality of life, and greater social justice that have politicized the process of resource allocation within them, intensified inflationary pressures, focused popular and elite-group attention on domestic concerns, and -- while increasing the scope of governmental responsibilities -- limited the freedom of action of political leaders and civil servants to make and implement policies both at home and abroad. In the recently independent nations of Asia and Africa, the search for new cultural and national identities is of central importance in these transitional societies struggling to maintain a precarious balance among their incompatible traditional and modern institutions, their inconsistent inherited and imported values and norms of behavior, and their conflicting

old and new particularistic groups. In quite different ways, these internal sociocultural changes in both types of countries -- as well as analogous developments in Latin America -- now constrain all nations to more directly and immediately self-interested conduct of their external economic and political relationships than during the postwar period, when they shared an urgent common interest in the reconstruction of the international system. These internal sociocultural developments and their effects on the external behavior of the nations comprising the international system justify calling the years since the mid-1960s and those lying ahead the period of the new nationalism.

The characteristics of the current period are explored in the study. In brief, international economic and political relationships are becoming more complex, ambivalent, interdependent and fluid than during the postwar period. Owing to the increasing economic and political capabilities of other nations, the determinative importance of the superpowers has been substantially reduced and their hegemonic control over their respective alliance systems has been narrowed geographically and considerably weakened. At the same time, their cold-war rivalry has moderated into "competitive coexistence" and they now both cooperate and conflict in deeply ambivalent ways. More and more developed and developing countries are becoming conscious of the possible kinds of economic and political leverage they have -- or think they have -- for influencing the behavior of others, and they are now more prone to shift their international relationships from cooperation to conflict and vice versa in accordance

with considerations of expediency. The dominant theme of international economic relations pursued in this way is the growing tension between the pressures to preserve the benefits obtained from the international integration achieved during the postwar period and the constraints arising from the internal sources of the new nationalism to protect or increase the nation's freedom of action and share of world income and employment -- a theme often complicated by continuing superpower rivalries. Thus, in the current period of the new nationalism, both the degree and the calculability of international integration are diminishing but neither process of reduction is likely to go so far as to result in substantial disintegration of the international system.

Both the quadrupling of petroleum prices by the OPEC countries and the onset of the severest recession since World War II are confronting developed and developing nations with major economic problems that could have serious political repercussions. Neither the reduction in petroleum consumption resulting from the price rise and the recession nor the increase in petroleum supplies from new and non-OPEC sources is likely to be big enough in the next year or so to bring down the price substantially or to necessitate such large production cuts as to cause the OPEC cartel to disintegrate. Hence, there will continue to be a significant transfer of real income to the OPEC members from the OECD nations and the other developing countries. However, by itself, this transfer is not likely to create very serious difficulties for the OECD nations as a group; although their real incomes will be lower, so long as the surplus OPEC funds are "recycled" for investment in them, their total output, and hence their employment, will be higher than it would otherwise be, all other things being equal. However, serious balance-of-payments problems are being created for those OECD and

developing nations that are not able to increase their exports or attract enough investment funds from the OPEC countries and other sources to offset the much higher import cost of oil. The adverse effects of this "recycling" problem are being magnified by the recession in the OECD nations. It is particularly severe in the United States and hence is having unfavorable repercussions on its major trading partners in the OECD nations and on its raw-material suppliers in the developing world. Assuming that appropriate policies are followed, however, the U.S. economy should begin to turn upward around the end of 1975, the rate of inflation should abate significantly in the course of the year, but unemployment will probably remain high for the next few years.

Both the changing nature of the international system and the socio-cultural changes within the United States set the limits of the possible for U.S. foreign policy in the current period of the new nationalism. On the one hand, as the kinds of problems analyzed in Chapters II and III make the need for U.S. actions increasingly pressing, opinion-leader and popular support for more positive pursuit of international objectives will probably prevail over the reductionist and largely self-protective tendencies of the late 1960s and early 1970s. On the other hand, in accordance with the characteristics of the new nationalism, domestic attitudes and pressures will continue to limit the extent to which U.S. foreign policy makers can forgo actual or potential benefits or incur increased costs in endeavoring to achieve system-reforming goals. Thus, the probable domestic changes are likely to permit a more active U.S. international role but at the same time to make it more directly and immediately self-interested than it was during the postwar period.

Chapter II - Problems and Prospects of Western Europe

When existing and prospective economic, political and psychocultural trends in Western Europe are considered in terms of their interactions, the uncertainties that lie ahead during the second half of the 1970s are strikingly reminiscent in certain respects of the anxieties about the future of Western Europe that alarmed Americans and Europeans during the second half of the 1940s. The outlooks for the four leading West European nations -- Italy, France, the United Kingdom, and Germany -- are analyzed in some detail, as is that for the European Community as an institution.

The West European nation in which severe economic problems already exist and serious sociopolitical consequences are most imminent is Italy. The essence of Italy's difficulty is that the immense increase in the import cost of fuels -- of which it has very slender resources of its own -- and the inadequacy of the surplus OPEC funds or their equivalent hitherto recycled to it have generated severe inflationary and balance-of-payments problems that, in turn, are magnifying to critical proportions the adverse effects of a basic institutional contradiction in Italian society. This is the fact that the development of the Italian economy since World War II has far outrun the development of the policy-making and implementing capabilities of its political and administrative systems. So long as world economic conditions are conducive to the expansion of Italy's exports -- as, except for brief interludes, they were until the winter of 1973-74 -- the Italian economy has been able to enjoy a high rate of economic growth with resulting improvements in living standards. The ability of the economic system to perform in this manner was not dependent upon the positive policies of the Italian govern-

ment but resulted fundamentally from the fact that the latter refrained from actions that nullified or impeded the dynamism, technological ingenuity and mobility of Italy's businessmen and workers. Now, for the first time since the completion of postwar reconstruction in the mid-1950s, Italy's economic problems are of such nature that the government must adopt and carry out restrictive policies designed to control inflation and reduce the payments deficit, while -- to make them tolerable to the Italian people -- it must move ahead with long-promised social reforms that it has hitherto failed to decide upon or implement. Its failure to do so does not result from a superficial or transient incapacity but reflects the fact that Italy's political system is still very traditionalistic, its democratic institutions are neither long nor deeply rooted, and its administrative personnel are largely lacking in modern managerial and technical skills.

In these circumstances, the more severe Italy's economic difficulties become during the remainder of the 1970s, the more likely it will be that the existing center-left coalition government will have to make a further "opening to the left" to obtain communist support, or will be overthrown by a right-wing military dictatorship, or will be superseded by a popular-front coalition that would sooner or later be dominated by the communists. The study analyzes the factors involved in and the relative probabilities of these possible developments. The most important action that could be taken by the United States and other OECD nations to help preserve a democratic regime in Italy would be to assure sufficient financing for its payments deficit to obviate the need for the Italian government to try to impose restrictive measures too severe for the country's political system to withstand.

The outlook for France is less worrisome than for Italy and there is a reasonable chance that it will be able to avoid serious economic difficulties that could lead to adverse political developments. But, in France, too, there is a basic institutional difficulty -- albeit different from Italy's -- that could be exacerbated to critical proportions by economic strains. Unlike in Italy, there is no question of the capabilities of the French government, and the French economy has enjoyed an even more far-reaching transformation since World War II than has Italy's. The essence of France's problem is the persisting rigidity of its social structure and the associated antagonisms and discontinuities in the inter-relationships of the main social groups. The traditional rigidities and class antagonisms within French society, inherited from the 19th century, have been largely responsible in the past for the relative stability of electoral support for right-wing, centrist and left-wing political parties, and for the tendency of the dissaffected groups to incubate their frustrations and resentments over long periods and then suddenly to express them in outbreaks of mass violence often triggered by unrelated events (as in May 1968). In recent years, the substantial modernization and rapid growth of the French economy have both induced and been fostered by the beginnings of a progressive dissolution of the inherited social rigidities. This process has been reflected particularly in the increasing fluidity of centrist voters, whose shifts to the right (as in 1968 after the May riots) and to the left (as in the 1974 presidential election) are now important determinants of electoral outcomes. However, for reasons explained in the study, the dissolution has not yet gone far enough nor have popular expectations for rising living standards and improved quality of life been sufficiently satisfied to eliminate the tendency toward unexpected outbreaks of mass violence.

If, during the remainder of the 1970s, balance-of-payments deficits restrict the French economy to slow or no growth, with corresponding too small increase or a reduction of real incomes, the resulting popular discontent would be likely to swing electoral support decisively to the left and/or to precipitate another outbreak of mass violence. The more and the less likely political repercussions are assessed in the study. In brief, the more serious France's economic difficulties become, the greater the probability that either a Socialist-led left-center coalition or a Communist-dominated popular-front regime would supersede the existing centrist coalition in the next election or that a wave of strikes, demonstrations and riots would render the present government ineffective. In either event, a military coup supported by the right would be likely to occur, with the possibility of a subsequent civil war. Hence, if there were to be severe payments deficits that France would be unable to finance through bilateral deals with the surplus OPEC countries, it would need assistance from the better-off OECD nations. However, owing to the importance apparently attached by a majority of the French people to the pursuit of an independent role in the international system, such aid to France -- especially from the United States -- would have to be given in ways that would not offend national sensibilities and thereby undermine popular support for a democratic regime.

Unlike in Italy and France, the current and prospective problems of the United Kingdom do not spring from fundamental institutional difficulties but rather from certain long-term psychocultural changes. Of basic importance are, on the one hand, the resentments of the lower-income groups against the ruling elites and the middle class generally,

and, on the other, the latter's traditional sense of cultural and moral superiority. The two have combined to make labor-management relations singularly ineffective and to impel the members of many trade unions (about half of British blue and white collar workers are organized) to press single-mindedly for a substantial redistribution of national income in their favor. At the same time, the long decline in Britain's power and influence in the international system both reflects and intensifies the weakening self-confidence of the upper-income groups and their increasing preoccupation with personal, family and local interests and enjoyment of their remaining wealth and privileges. These basic attitudes underlie the strong consumption and social-welfare orientation of the U.K. economy, its inadequate rate of capital investment, and its tendency to run large payments deficits whenever its growth rate increases. The results have been the "stop-go" macroeconomic management policy that both Conservative and Labour Party governments have been constrained to follow since World War II, and the fact that the United Kingdom now has one of the lowest per capita incomes among the OECD nations.

Although the existing Labour Party government is unlikely to implement all of the nationalization and social-welfare demands of its influential left wing, it will undoubtedly follow sufficiently socialist income-redistribution policies, on the one hand, to satisfy trade-union expectations and, on the other, to inhibit a revival of morale and confidence in the future on the part of businessmen and investors. Thus, the task of coping with the large payments deficits resulting from the oil price rise is made doubly difficult. Nor is it by any means certain that, as many opinion leaders in the United Kingdom expect, the output of North

Sea oil will be sufficient by the end of the decade to eliminate these deficits and make possible a new era of high economic growth and rapidly rising real incomes for the great mass of the people. As the study explains, it is at least as probable that interclass resentments will persist, economic growth will lag, and the United Kingdom will drift into a kind of disagreeable socialism equally unsatisfactory to its opponents and to its supporters. In any event, the United Kingdom will probably require help in financing its payments deficits during the remainder of the 1970s.

Although also psychocultural in nature, the specific problem faced by West Germany is quite different from that of the United Kingdom. Germany's economy is by far the strongest in Western Europe, its monetary reserves are the largest hitherto accumulated by any nation, and it should be able to cope effectively with any of the international economic difficulties likely to lie ahead. Indeed, so favorable are its current situation and future economic prospects that Germany is likely to be the major source within Western Europe for the financial help required by its fellow members in the European Community. And, that prospective role points to the problem which could lie ahead. During the first half of the 20th century, Germany's dramatic design -- the sense of a nation's identity and destiny by which it justifies its existence to itself and to outsiders -- was shattered by defeats in two world wars, by the shame of Nazi atrocities, and by the division into communist East Germany and democratic West Germany after World War II. During the postwar period, the latter developed two new self-justifying goals: reunion with East Germany and participation in a West European political and economic union based on Franco-German recon-

ciliation and partnership. By the early 1970s, however, neither goal appeared likely to be attained in the foreseeable future for reasons explained in the study. In consequence, a sense of aimlessness and a vague anxiety about the future now pervade German society despite the unprecedented prosperity enjoyed by the German people. Indeed, this prosperity contributes to the current unease, generating, on the one hand, a kind of crass materialism and, on the other, feelings of personal guilt and social dissatisfaction that have led to the revival of Marxism (mostly of New Left varieties) in the universities and among young workers. At the same time, an opposite move to the right is taking place on the part of older voters alarmed by inflation and recession and worried that social reforms may be too drastic. These reactions are slowly beginning to polarize German politics toward the extremes.

During the remainder of the 1970s, however, the main danger is not likely to be the intensification of this slow polarization but rather the filling of West Germany's psychocultural vacuum by an emerging sense of national identity and destiny that would revive an hegemonic and imperial self-image. Such a possibility is implicit not only in the fact that West Germany will be disproportionately strong economically and will probably be providing financial aid to its neighbors but also in the likelihood that its role in NATO will increase relative to that of the others as economic pressures compel them to reduce their military establishments. Hence, the United States and other OECD nations -- which, in their own interest, will be fostering German acceptance of greater economic and military responsibilities -- need to help assure that these beneficent German actions will be undertaken through institutional contexts and multilateral arrangements capable of inhibiting the emergence of a sense of German national superiority and hegemonial destiny.

The study also sketches briefly the economic problems and political dangers likely to lie ahead for Portugal, Spain, Greece and Yugoslavia.

The European Community was explicitly intended by its six founding members as a major step toward an eventual political and economic union of some kind, and that conception remains the official institutional goal of the efforts of its present nine members to expand and deepen their mutual integration. Nevertheless, since the completion of the customs union -- including the arrangement for free trade in agricultural products known as the common agricultural policy -- in the mid-1960s, no significant advance toward greater unification has occurred. Most of the common policies that the Community has been endeavoring to negotiate would not be in themselves significant new advances in unification but are designed to buttress the customs union by equalizing the various factors affecting the conditions of competition within it. The one effort to move significantly beyond the customs union -- the proposal for monetary unification adopted in the early 1970s -- was nullified by the subsequent floating of sterling, the French franc and the lira, and attempts to revive it will have little chance of success in the international monetary conditions prevailing in the wake of the oil price rise. At bottom, the merging of national sovereignties in a West European economic and political union of some kind is highly unlikely in view of the domestic constraints and international pressures of the period of the new nationalism, as explained in the study.

In these circumstances, the European Community has become in effect a pragmatic means for bolstering European nation-states and not for superseding them, as its official justification still insists. For, it enables the West European nations to act jointly to advance or protect their

national interests in the international economic system in specific ways that supplement or substitute for individual national efforts, which lack sufficient size or influence to be effective in the rigorous conditions of the second half of the 1970s.

As the study explains, the same expedient approach now characterizes the attitude of the West European nations to the United States. In effect, cooperation with the United States in coping with particular international problems is another pragmatic means that these countries are using to advance or protect their national interests in addition to their joint actions through the European Community and their individual national efforts. And, because the problems confronting them are likely to be more severe during the second half of the 1970s than any they have had to face since the second half of the 1940s, their willingness to cooperate with the United States is now greater and more evident than during the past ten years, when they had a strong sense of belonging to a uniting Europe destined to play an increasingly important role in the world. At the same time, domestic constraints and international pressures make conflicts between Western Europe and the United States inevitable. And, because the economic or psychopolitical interests at stake are felt to be compelling, the West European nations will pursue them as effectively as they can with the individual and joint means at their disposal. Thus, transatlantic relations in the current period are already and will continue to be deeply ambivalent.

The study discusses the main kinds of economic and political problems on which transatlantic cooperation is likely and those in which conflicts

will probably arise. In the first category, the most pressing need for and the greatest likelihood of economic cooperation is with respect to financial aid to those West European nations whose balance-of-payments deficits could be so large as otherwise to necessitate restrictive measures likely to provoke adverse political consequences. The most urgent need for political cooperation arises from the likelihood that the economic difficulties of most European members of NATO will probably lead to reductions in their military establishments, which will make it difficult for the United States to maintain its contribution to NATO and will have grave consequences for NATO's future effectiveness.

The main types of transatlantic economic conflicts likely to arise over trade, investment and other economic relationships are identified. The study also projects the more serious conflicts with the United States that could be provoked by the effects on U.S. multinational companies and banks operating in Western Europe of the nationalization, social-welfare and other income-redistributing measures likely to be instituted by left-wing and popular-front coalition governments. The consequences for political and military relationships between the United States and Western Europe of the coming to power of such regimes are also sketched.

Finally, some general guidelines for U.S. policy are suggested for dealing with the more serious of the economic, political and military problems likely to arise in U.S. relations with Western Europe during the remainder of the 1970s (see pp. 11 69-77).

Chapter III - The Prospective Instabilities of the Northwest Indian-Ocean Region

This chapter deals with the problems that could confront the United States during the next five years or so in the region stretching from Egypt and the Horn of Africa on the west to the nations of the Indian subcontinent on the east. It is designated as the Northwest Indian-Ocean region because all of the countries considered in the chapter border on the Indian Ocean or its two major northwestern extensions, the Red Sea and the Persian Gulf. The study analyzes the interactions between two types of instabilities: those inherent in the process of sociocultural change within the leading nations of the region -- Egypt, India, Iraq, Iran, and Saudi Arabia -- and those arising from the relationships among these countries and the two superpowers, the Soviet Union and the United States.^{*/}

Despite the global nature of the cold war during the postwar period, the Northwest Indian-Ocean region was surprisingly free of superpower rivalries and confrontations in those years. In the course of the 1960s, however, the situation gradually changed as the last vestiges of the historical British hegemony over the region were withdrawn, the United States and especially its allies in Western Europe and Japan became increasingly dependent upon Persian-Gulf oil supplies, the Soviet Union steadily expanded its military and economic aid to Egypt, Syria, Iraq, South Yemen, and Somalia and began to build up its naval presence in the Indian Ocean, and the Arab-Israeli conflict intensified. The quadrupling of petroleum prices by the OPEC countries in the winter of 1973-74 and its international repercussions have confirmed the importance of the region to the rest of the world. In consequence, its instabilities now

^{*/} As a long preexisting problem, the Arab-Israeli conflict is outside the scope of the study but its probable effects on the other interactions are taken into account.

constitute a major potential danger both to world peace and to the effective functioning of the world economy.

The study argues against the prevalent view in the United States that this change in the region's international importance is solely or mainly the result of the growing Soviet involvement in regional affairs. Instead, the study explains that, although Soviet actions seriously complicate the problems of regional instability, they are neither the basic cause of these difficulties nor are they any more capable of resolving them than actions by the United States would be. Essentially, the greater or lesser internal instability of all of the nations of the region is inherent in the process of sociocultural change from traditional through transitional to modern societies. Of the five leading nations analyzed in the study, Iran and Egypt are the least unstable, Saudi Arabia and Iraq are the most unstable, while India occupies an intermediate position.

Iran is the most stable because the Shah has been able to assure support for his regime by the military, which is likely to be strong enough to prevent disaffection among the lower-echelon bureaucrats, unemployed students and lowest-paid or unemployed urban laborers from erupting into a sustained revolutionary effort. In Egypt, the military regime is in firm control, although military or economic setbacks could result in a change in its leading personalities. In Saudi Arabia, the traditional and religious supports for the autocratic rule of the Saudi family are being eroded at an increasing rate by the modernization process, itself accelerated by the enormous rise in oil revenues; sooner or later, these sociocultural changes are likely to lead to a complex pattern of

Internal instability comprising struggles among rival princes and factions within the large Saudi family and its collateral branches and attempts at coups by the modern-educated regular army officers of by the traditionalist national guard supported respectively by the new modern elites and the bedouin tribes. Iraq is confronted with a multitude of problems -- the factional rivalries within the ruling Baathist/military regime, conflicting religious and ethnic groups, the open revolt of its Kurdish minority, lagging economic development, border disputes with Iran, and others -- that continually threaten to precipitate internal unrest and help to impel it into aggressive behavior toward its neighbors. In India, particularistic struggles among traditional castes, sects and ethnolinguistic regions, the conflicts among the political parties, and the self-seeking competition of the modern elites for power, status and income are compounding the difficulty of coping with mounting demographic and economic problems.

The study analyzes six possible patterns of regional instabilities that could be generated during the remainder of the 1970s. They include the external repercussions of internal disorder in Saudi Arabia, Iraqi provocation of its neighbors, Iranian efforts to achieve paramountcy in the Persian Gulf and Arabian Sea, the disintegration of Pakistan, Indian expansion into the Persian Gulf, and internal disorder in the small states on the southern shore of the Persian Gulf, including Oman.

The study assesses the implications of the existing and prospective internal and intraregional instabilities for U.S. policy. It argues that, insofar as the U.S. commitment in the Arab-Israeli conflict permits, the

United States should strive to achieve a neutral position within the region, which would enable it to mediate more effectively in the event that one or more of the foregoing patterns of interactions -- or other forms of regional instability -- were to occur. Some general guidelines are suggested for coping with the more and the less likely threats to the one vital U.S. interest in the region -- an adequate flow of petroleum from the Persian Gulf (see pp. III 51-59).

CHAPTER I

THE NATURE OF THE INTERNATIONAL SYSTEM DURING THE REMAINDER OF THE 1970s

This chapter explains in broad outline how the basic structure of the international system and the characteristic modes of behavior of the various kinds of nations comprising it have been changing in recent years and are likely to develop during the remainder of the 1970s. This changing institutional structure and set of behavioral norms provide the general framework that both expresses and shapes the specific interactions -- cooperative and conflicting -- among the nations composing the system. Hence, at least the main outlines of this basic constitution and of its implications for U.S. policy need to be sketched in this chapter before the trends and problems analyzed in the subsequent chapters can be adequately understood.

Two periods can be distinguished in the evolution of the international system since World War II. The two decades from the mid-1940s to the mid-1960s constituted the postwar period of system reconstruction in accordance with the competing world-transforming designs of the two superpowers, the United States and the Soviet Union. Under its hegemonic leadership, each superpower organized its allies and dependent states into a more or less integrated economic and political order, and world politics during the postwar decades was dominated by the bipolar cold-war rivalry between them. By the mid-1960s, however, the institutional structure of the international system and the modes of behavior of the nations comprising it had changed sufficiently to warrant designating the past ten years and those lying ahead in the foreseeable future as a new period. It is called here -- as in previous writings of the principal investigator -- the period of the new nationalism.

In the current period, the international system has been "nationalized" in two senses of the term. First, the number of nations comprising the system has greatly increased: 70-odd new nation-states have come into existence since World War II. Second, and more important, the behavior of all nations in this more differentiated system has become markedly more nationalistic. True, nation-states always try to act in accordance with the perceptions and conceptions of national interest that predominate within them at any particular time. Nevertheless, in comparison with the postwar period, the members of the international system today tend to interact in accordance with narrower and more direct perceptions of their national interests, more compulsive awareness of their distinctive national identities, and more self-concerned conceptions of their roles. These differences of degree express the mutually supporting interactions between the sociocultural changes within the various kinds of nations and those in their relations with one another that reflect shifts in their relative economic, political and military capabilities and in the nature of the problems thereby generated. These changes also justify designating today's nationalism as new. Whereas 19th- and early 20th-century nationalism was most characteristically manifested in aggressive and expansionist actions, contemporary nationalism typically takes the form of more inward-concerned and self-protective behavior, especially in the high-income nations of North America, Western Europe and the Pacific.

The internal sociocultural changes underlying the "nationalization" of the international system are briefly analyzed in the next section. The external changes in the interrelationships of the nation-states comprising it are outlined in the subsequent section.

The Sociocultural Roots of the New Nationalism

In the newly independent Asian and African countries, the drive to forge new cultural and national identities has been the most important integrating force in these transitional societies, composed of inconsistent traditional and modern cultural and institutional elements and of conflicting particularistic groups. As this drive integrates them internally, it also impels them externally to differentiate themselves from other nations and to resent and resist the constraints imposed by the integrated international system on their national decision making. Although the older nations of Latin America have long since developed their senses of national identity, they too have been internally divided by the struggles among competing groups over modernization of their systems of institutions, values and behavioral norms and over distribution of the fruits of the accompanying economic growth. In consequence, they too are impelled to obtain greater and more immediate benefits in the international system and equally to resent the constraints on their national freedom of action imposed by international economic integration.^{1/}

Hence, the objectives sought by Asian, African and Latin American countries in the international system are conflicting. On the one hand, their desire for economic growth makes their need for international trade, investment and aid urgent, and -- voluntarily or perforce -- many of them have been drawn into integrated preferential economic relationships of various kinds with the European Community, the Soviet Union, Japan or the United States. On the other hand, they are seeking to improve their terms

^{1/} For a fuller analysis of the nature and implications of nationalism in the developing countries of Asia, Africa and Latin America, see Theodore Geiger, The Conflicted Relationship: The West and the Transformation of Asia, Africa and Latin America (New York: McGraw-Hill for the Council on Foreign Relations, 1967), Chapters Three and Four.

of trade and investment relative to the markets and capital resources of the richer countries, to increase their national freedom of action with respect to their domestic and foreign policies, and to expand their own control over their national economies, especially their natural-resource sectors. With varying degrees of intensity, all now envisage a redistribution of world income in their favor, a goal not shared by the high-income nations of North America, Western Europe and Japan -- nor, for that matter, by the Soviet Union.

During the 1950s, the United States and the Soviet Union had a common conception of the role of these new nations in the international system. It was that, constrained by their own political and economic weaknesses and the external pressures of the global rivalry between the superpowers, few if any of them could resist aligning themselves either with the Soviet Union or with the United States. And, during the 1950s and early 1960s, many of these nations were induced or compelled by internal difficulties or external threats to affiliate in a variety of ways with one or the other superpower -- or with one of its allies. Nonetheless, some were able to remain unaligned from the beginning and, in the course of the 1960s, most of the others tried to reduce the restraints on their national freedom of action resulting from their direct or indirect dependence on the superpowers and their allies. By the end of the decade, the Group of 77 (actually more) had emerged to give independent representation and influence to the interests of the developing countries in international negotiations.

In the high-income nations of North America, Western Europe and

the Pacific, their unprecedented economic growth during the postwar decades provided resources for realizing social values and personal aspirations that had hitherto been regarded as attainable, if ever, only in some distant future. Hence, in the course of the 1960s within all of these countries -- although in different ways and in varying degrees -- the number, diversity and cost of national goals were increasing as expectations of rising material consumption, greater social justice, and improved quality of life became more pressing. The consequent conflicts over national priorities and the ways to achieve them politicized the process of resource allocation, intensified inflationary pressures, focused popular and elite-group attention on internal concerns, and greatly expanded the functions of governments, which are the institutional means both for resolving competing claims on resources and for carrying out the resulting allocations to particular purposes. These basic sociocultural changes have had major implications both for the domestic politics of the developed nations and for their participation in the international system.

With respect to domestic politics, the effects have been deeply ambivalent. On the one hand, the politicizing of the process of resource allocation, the greater number and diversity of the groups and organizations active in politics, and the strength of the interests and the intensity of the feelings involved limit and warp the efforts of political leaders and civil servants to reconcile competing claims, formulate practicable programs, and implement them equitably and efficiently. On the other hand, the expanding scope of governmental responsibilities increases the determinative importance of the public sector of the national economy and

Involves official regulatory and administrative agencies ever more broadly in the life of the society and more deeply in the internal operations of its constituent institutions and groups.^{2/}

These interacting tensions produce a characteristic domestic political phenomenon first identified by the great 19th-century historian and sociologist Alexis de Tocqueville in his studies of the background of the French Revolution and subsequent periods of social unrest. As the condition of a particular social group or of the great mass of the people improves, the gains already achieved stimulate expectations of greater and faster progress. The frustration of these rising expectations by the resistance or incompetence of the ruling elites (as in the French Revolution) or by economic or political constraints beyond their control (as in the developed nations today) usually leads to more aggressive and radical political action by the groups involved which, in extreme circumstances, may culminate in social revolution. The de Tocqueville effect is the opposite of the process envisioned by Marxist theorists: that the increasing impoverishment of the masses by the contradictions of the capitalist system results in its eventual overthrow. Certainly, in view of the unprecedented rise in the prosperity of the developed nations over the past 25 years, the de Tocqueville effect provides a more plausible explanation than Marxist theory of the leftward drift of domestic politics in Western Europe, as explained in Chapter II, as well as in high-income Pacific countries.

These complex sociocultural changes and conflicting trends have heavily influenced the participation of the developed nations in the international system. In general, as the domestic pressures on and the respon-

^{2/} For a fuller account of the historical background and current sociocultural roots of the new nationalism in North America, Western Europe and Japan, see Theodore Geiger, The Fortunes of the West: The Future of the Atlantic Nations (Bloomington: Indiana University Press, 1973), Chapter Two.

sibilities of their governments increased, their foreign-policy makers have had less scope to undertake bold initiatives abroad and to make compromises and concessions in resolving international issues.

The effect of domestic changes and tensions on American conceptions of the international role of the United States has been especially important. The active sense of world-transforming mission that characterized American attitudes in the postwar period weakened rapidly after the mid-1960s under the pressure of domestic conflicts and inward concerns and the growing dissension over the long, inconclusive U.S. involvement in the Indochina War. By the end of the decade, U.S. foreign-policy makers no longer enjoyed the elite-group and popular support that they had during the postwar period either for a world-transforming conception of the U.S. international role or for an allocation of resources to international purposes of a size comparable to that of the earlier years in relation to the total resources available.

Changing International Relationships

With the completion of its customs union in the mid-1960s and its subsequent enlargement to include all West European nations (except Spain) as full members or industrial free-trade affiliates, the European Community became the world's largest trading entity, with influence in the international economic system second only to that of the United States. The monetary reserves of its members grew rapidly and, by the mid-1960s, their total substantially exceeded that of the United States. The foreign investments of E.C. countries expanded greatly in the course of the decade, and their capacity for technological innovation, managerial improvement and competitive dynamism also increased markedly.

Whereas during the postwar period the West European nations had mainly related bilaterally to the United States, during the second half of the 1960s a parallel collective relationship through the Community became increasingly important. As European economic capabilities grew and internal nationalistic pressures strengthened, the Community's members were less and less willing or able to make concessions to the United States with respect to the issues in transatlantic political and economic relations. On the one hand, the Europeans continued, as in the postwar period, both to depend upon the U.S. nuclear guarantee for their security and to seek to preserve the benefits derived from their high degree of economic integration with the United States. On the other, they increasingly resented U.S. domination of NATO and the major influence that the U.S. economy exerted on their own. In consequence, transatlantic relationships became much more difficult in the late 1960s and early 1970s than they had been in the postwar period.

Japan, too, enjoyed unprecedented economic growth and rising living standards throughout the 1960s and, by the end of the decade, had the third largest national economy in the world (after the United States and the Soviet Union). Japan became a major trading partner not only of the United States but also of China and other nations in East and Southeast Asia. Its monetary reserves grew rapidly, especially during the late 1960s, and the yen became one of the world's strongest currencies.

The most dramatic manifestation of the change in U.S. international economic capabilities relative to those of the European Community and Japan were the events of August 15, 1971, when the dollar was devalued,

its convertibility into gold was terminated, and an import surcharge was imposed for balance-of-payments reasons. Subsequent efforts to restabilize exchange rates in the Smithsonian Agreement of December 1971 proved ineffective and, under the pressure of necessity, the fixed exchange-rate regime of the postwar period had to be abandoned. In its place, a regime of managed floating of exchange rates among the major international currencies emerged in the early 1970s that has eased the balance-of-payments adjustment problems of the OECD countries. Equally important, by untying their currencies from the U.S. dollar, the managed floating regime has substantially reduced the influence of changes in the U.S. money supply on those of the OECD nations, thereby enabling the larger European countries and Japan to follow more independent macro-economic policies.

Although its economy continued to be of minor significance in the international economic system, China nevertheless became an increasingly important participant in world politics. After the break with the Russians in 1960, China's relationship with the Soviet Union was characterized by deepening suspicion of one another's intentions, border incidents, and rivalry for the leadership of revolutionary forces throughout the world. China sought to develop its own nuclear weapons and intercontinental missiles as rapidly as possible for protection against both the Soviet Union and the United States, then heavily engaged in Indochina. By the early 1970s, however, U.S. disengagement in Southeast Asia, continued Chinese perception of a Soviet menace, and the abatement of China's internal tensions generated by its "Cultural Revolution" led to a rapprochement

with the United States and expanding Chinese economic and political relationships with other nations.

Finally, in the course of the 1960s, the relative international position of the Soviet Union also changed substantially. On the one hand, the Soviet Union attained nuclear parity with the United States and it pushed ahead with the building of an all-oceans naval capability. On the other, the defection of Yugoslavia, Albania and China, the comparative independence of Rumania, and the need to keep its troops in the other East European countries in part to preserve its control over them marked for the Soviet Union as significant a decline in its hegemonic power as did the parallel loss of influence by the United States over the West European nations and Japan.

The Characteristics of the Current Period of the New Nationalism

Although the current period can be said to have begun in the mid-1960s, its distinctive characteristics have only become fully apparent in the wake of the world energy crisis of 1973-74.

For example, before the winter of 1973-74, it seemed likely that, despite the effects of the new nationalism in slowing the process of European unification, the internal and external pressures impelling the members of the European Community to deepen their integration and to operate as a unit in world affairs would sooner or later constrain them to form a confederal arrangement of some kind. In that event, the Community would have sufficient political and economic unity, as well as large enough resources, to constitute another great world power alongside the United States, the Soviet Union, China, and Japan. Since the crisis, as explained in Chapter II, such an outcome seems much less probable

than that the Community will not be able to increase its economic and political unification significantly. Indeed, it may be that the Community will have difficulty even in preserving the customs union and common agricultural policy under the strains imposed by the balance-of-payments problems and the possible adverse political developments in some of its members.

Another major determinative characteristic of the current period confirmed by the world energy crisis is the continued preeminence of the two older superpowers, the United States and the Soviet Union. True, as pointed out in the preceding section, the differentiation of the international system reflects the increasing power of other nations -- for example, China, Japan and Germany -- relative to that of the superpowers, and the latter's much diminished influence over their allies and client states. Nonetheless, both the United States and the Soviet Union continue to have the will and the ability to withstand the efforts of any other nation or group of countries to compel them to behave in ways contrary to their own conceptions of their interests. For example, in contrast to the West European nations and Japan, the United States resisted the effort of the Arab states to use the oil embargo as a means for compelling it to change its policy toward Israel. The fact that the Soviet Union and the United States have continental economies -- that is, economic systems that are so large and resource diversified as in the aggregate to be very little dependent upon foreign trade -- makes them relatively immune to pressures of the kind that the Arab nations tried to apply. Moreover, they are still able, if they wish, to help their allies and client states. Thus, as will be explained in Chapter II, it is quite possible that the United States could once

again provide some form of aid to European countries experiencing unmanageable balance-of-payments deficits or severe internal political and economic difficulties in the foreseeable future. In other words, although the U.S. capacity to influence the policies and actions of the European nations is substantially less than in the postwar period, they continue to be dependent on the United States and could become even more so in the years ahead -- an asymmetrical relationship that, by its nature, breeds frustration and resentment on both sides.

In the current period, relationships between the two older superpowers have become more complex and ambivalent than during the postwar decades. Changes both within the two nations and in the international system have gradually moderated the all-pervasive rivalry of the cold war into "competitive coexistence". On the one hand, each superpower no longer interprets every event unfavorable to its interests that occurs anywhere in the international system as caused by the machinations of the other and as likely to benefit the other's power position at the expense of its own. On the other hand, the logic of their mutual distrust of each other's intentions continues to block substantial arms limitation, to foster military research and development, and to impel them to maintain, if no longer always to increase, their influence in regions and countries they regard as strategically important. The two superpowers have an overwhelmingly compulsive common interest in avoiding a nuclear war between them, a less compelling but still important common interest in trying to prevent the spread of nuclear weapons capabilities to lesser powers, and a significant common interest in inhibiting conflicts within and

among smaller nations that could involve the superpowers in direct confrontations capable of escalating into a world nuclear war. Thus, the two superpowers both cooperate and compete in a deeply ambivalent relationship in which they are motivated simultaneously to protect the stability of the international system and to foster rival processes of sociocultural change. However, since the relationship is more nearly symmetrical in terms of relative power and mutual respect, it tends to be less frustrating and resentment-generating than that between each superpower and its dependent allied and client states.

Despite the efforts of the superpowers, it seems likely that the domestic and international pressures of the period of the new nationalism will sustain the process of nuclear proliferation. India's recent explosion of a nuclear device will probably prove to have been the decisive event. Not only does it provide a justifying example to other aspiring nations but it also is likely to set off a chain reaction of perceived power imbalances among contiguous states in the Northwest Indian-Ocean region analyzed in Chapter III (i.e., Pakistan, Iran, Iraq, and Saudi Arabia, as well as Egypt and Israel) that will sooner or later impel them to develop, buy or otherwise acquire nuclear capabilities. Other nations that might eventually obtain nuclear weapons by one means or another could include Japan, Brazil, Argentina, Sweden, South Africa, and perhaps even Germany. Nuclear proliferation, especially in the Northwest Indian-Ocean region, would mean that nuclear weapons would be likely to be used in future armed conflicts among the states involved. In such situations, the superpowers could be under pressure to intervene to prevent destruction of their favored antagonist, with resulting danger of direct confrontation between them. Thus, the lessened probability that a world nuclear war will be

provoked by direct superpower rivalries -- as it might have been during the postwar period -- is at least partly offset by the growing danger that conflicts among smaller powers with nuclear capabilities could involve the superpowers willy nilly.

Leaving aside the possibilities of armed conflict, nuclear and nonnuclear, the current period is already and will continue to be dominated by the tensions between the international integration inherited from the postwar period and the disintegrative pressures of the new nationalism. International integration means that national governments give up voluntarily or perforce some of their sovereign economic and political powers, and their freedom of action in both internal and external policies is correspondingly reduced. But, the domestic pressures of the new nationalism impel them to perceive the constraints imposed by international integration as involving unacceptable losses -- actual or potential -- of economic welfare, political influence and psychocultural independence. Hence, the participation of nations in the international system is now more directly and narrowly self-interested than during the postwar period. Then, they had an overwhelming common interest in the reconstruction of a functioning international political and economic system and a more or less commonly perceived external menace in the Soviet Union. At the same time, the United States had the prestige and the disproportionate power for persuading or constraining them to behave in accordance with the U.S. conception of a reconstructed international system. Today, in contrast, a functioning international system exists; the external menace of the Soviet Union has receded; and the United States lacks the prestige for persuading, and is unwilling to exert the

proportionately greater power required for compelling, other nations to concur in its conception of international relationships. The general common interest of the members of the international system in maintaining its effective integration is offset by their particular competing interests in the relative distribution of the benefits and costs of international integration.

In consequence of these conflicting trends and the resulting policy dilemmas, international relationships in the current period are much more fluid than in the postwar period. Nations are becoming more and more prone to shift relationships from collaboration to conflict and vice versa as they perceive their interests changing in different problem situations. Thus, not only do the West European states cooperate with one another and with developing countries against the United States but also, during the oil embargo in the winter of 1973-74, they did not hesitate to compete among themselves to make the best bilateral deals they could with the petroleum-producing nations despite their mutual obligations in the European Community to act as a unit in international trade matters. The developing countries of Asia, Africa and Latin America are similarly inclined to shift relationships as their interests change. United in the Group of 77, they lose no opportunity to denounce the high-income OECD nations in order both to reinforce their demands for a redistribution of world income and to obtain the psychic satisfactions involved.^{3/} But, neither do they hesitate to press the conflicting interests among them during actual negotiations over trade, investment, the law of the sea, and other economic issues,

^{3/} For an analysis of the psychocultural factors involved, see Geiger, The Conflicted Relationship, cited, pp. 119-124.

and to collaborate with the West European nations, the United States and Japan against one another when such alignments suit their purposes.^{4/}

In pursuing their national interests through both conflicting and collaborative relationships, developed and developing nations now have a greater variety of means at their disposal. Unlike in the postwar period when military power was essential for international influence, economic power can also be of determinative importance today, and is being used to realize political as well as economic objectives. This is, of course, the often-noted "politicizing" of international economic relationships that has occurred in recent years. Both developing and developed countries now try to use access to their exports -- and no longer only access to their import markets -- as means to achieve or protect domestic objectives (e.g., maintain a monopoly export price, limit domestic shortages and price rises, foster processing industries, etc.), and as bargaining counters in international negotiations. This expansion in the diversity of trade policies that nations are willing and able to use is paralleled by an analogous change in investment policies that also intensifies the potential for international economic disputes. As C. Fred Bergsten points out, the growing insistence of capital-importing nations -- both developing and developed -- that incoming foreign investment should more directly and substantially serve their national interests (e.g., through job and export creation, etc.) is beginning to be matched by domestic pressures in the capital-exporting nations for imposition of new or greater restrictions (e.g., to protect jobs and exports, etc.) on the kinds and size of investments

^{4/} For an analysis of the shifting collaborative and conflicting relationships of the countries engaged in the negotiations on the law of the sea, see Roger D. Hansen, "The North-South Split and the Law of the Sea Debate: The Dominant Pattern?" (Paper prepared for the Ocean Policy Project of the School of Advanced International Studies, Johns Hopkins University, October 1974).

that their multinational companies can undertake abroad.^{5/} Through these and other economic means, countries are impelled by the interactions among them to seek with increased intensity -- if not always with greater success -- to augment or protect their shares of world income and employment and even to influence one another's political actions.

Thus, in the period of the new nationalism, the international system is beginning to manifest neomercantilist characteristics analogous to those of the 17th century. The difference is that today, unlike in the period of full-blown mercantilism, the nations resorting to such tactics are also in greater or lesser degree restrained in using them by recognition of their stake in preserving the benefits of international integration. Nevertheless, it is within the limits of the possible that some nations may not be sufficiently willing or able to restrict the use of their economic power. Excessively burdensome or even unmanageably severe problems could thereby be generated for other countries, developed or developing, that have the capacity to retaliate in ways more damaging than imposing import or export restrictions of their own. Such retaliatory measures could include covert intervention in the domestic politics of the offending nations to bring about a change in policy or even a change of regime, the threat of force and, at the extreme, armed invasion.

The nationalizing and politicizing of international economic relationships in the current period make it unlikely that substantial

^{5/} C. Fred Bergsten, "Coming Investment Wars?", Foreign Affairs, Vol. 53, No. 1, October 1974, pp. 135-152.

further economic integration will be achieved among the developed nations of North America, Western Europe and the Pacific. The domestic pressures of the new nationalism are alone sufficient to inhibit a move toward much greater freedom of trade and investment than now exists. It is possible, however, that present and forthcoming international economic negotiations will result in agreement among the developed nations on codes of behavior and consultative arrangements governing import and export restrictions and subsidies, exchange-rate practices, and capital and investment controls, and the conditions under which the permitted measures could be applied. In addition, except for the possibility that the difficulties of some of its members might undermine the E.C.'s customs union, regional and other types of formal or implicit discriminatory economic arrangements are likely to persist as the countries involved find the limited integration provided by such blocs more directly beneficial or less restricting than universal nondiscriminatory relationships.^{6/} Conversely, it is equally unlikely that the international economic system will substantially and permanently disintegrate even though world economic conditions and their own internal problems may from time to time compel developed nations in North America, Western Europe and the Pacific to impose major trade barriers and foreign-exchange and capital controls.

In sum, international political and economic relationships in the current period are becoming much more complex, ambivalent, interrelated

^{6/} For an analysis of the prospects of blocs, see Ernest H. Preeg, Economic Blocs and U.S. Foreign Policy, (Washington, D.C.: National Planning Association, 1974).

and fluid than they were during the postwar period. The dominant theme of international relations is the growing tension between the pressures to preserve the benefits of international integration and those to protect or increase a nation's freedom of action and share of world income and employment -- a theme often complicated by continuing superpower rivalries. More and more countries are becoming conscious of the possible kinds of leverage they have -- or think they have -- for influencing the behavior of others in the international system and more willing to use these means of power, individually and in groups. For these and other reasons, problem situations within and among nations are arising with increasing frequency and have become more difficult to resolve. And, when agreements can be reached, they are often sufficiently unsatisfying to the participants to leave lingering frustrations and resentments that aggravate future disputes. In these circumstances, both the degree and the stability of international integration are diminishing and will probably continue to decline moderately, even though they are unlikely to go so far as to result in substantial disintegration of the international system.

The World Economic Outlook

Before considering the implications for U.S. policy of the characteristics of the international system in the current period, account needs to be taken of the outlook for world economic conditions in the light of the quadrupling of petroleum prices and the onset of the severest recession since World War II. Treated at greater length in the Appendix, the reper-

cussions of these developments are only briefly summarized here.

For the remainder of the 1970s and probably for the years beyond, the essence of the problem of macroeconomic policy faced by the United States and the other OECD nations can be summed up as follows: how to maintain balanced growth of capacity, demand and employment while at the same time financing capital expansion, coping with deterioration in the terms of trade, and not incurring excessively burdensome external debt obligations. Due to the fact that the expansionary boom of the early 1970s was synchronized in the OECD nations, inflationary pressures were magnified both directly and through the resulting rise in the prices of internationally traded commodities and they were compounded by the quadrupling of oil prices in the winter of 1973-74. Then, the restrictive measures imposed to restrain inflation and the shift of real income to the OPEC countries initiated a simultaneous recessionary downturn in the United States and other OECD nations. Because the OECD nations as a group produce over 80 percent of the total output of the countries comprising the international market economy, economic developments in the former will very strongly affect economic conditions in the developing countries of Asia, Africa and Latin America, including even those of the OPEC members.

For reasons explained in the Appendix, it is unlikely that petroleum prices will decline significantly in the short term, the next 12 to 24 months. Neither the restriction of demand in consequence of high prices, conservation measures and recession nor the increase of supply from new and non-OPEC sources are likely to be great enough during this period to require such large limitations of output by the OPEC members as to undermine the solidarity of the cartel and lead to a substantial -- as

distinct from a marginal -- reduction in prices. However, over the medium term -- the next five years or so -- conservation measures and, more importantly, increased petroleum production from new and non-OPEC sources should begin to exert a more powerful effect on the cartel with a reasonable probability that the oil price would start to decline significantly, perhaps by about a third below present levels by the early 1980s.

Even so, an unprecedentedly large income transfer from the OECD nations (and many developing countries) to the OPEC members has already occurred and, as implied by this price projection, will continue to take place over the medium term. The questions are: what effect will the transfer of real income have on the economic condition of the OECD nations during the remainder of the 1970s (i.e., the transfer problem); and, will certain OECD nations (as well as developing countries) experience unmanageable balance-of-payments deficits because of their inability to expand exports sufficiently and to attract enough OPEC investment funds or their equivalent (i.e., the "recycling" problem)?

As to the transfer problem, so long as the OPEC members with surplus funds -- that is, with oil revenues over and above their expenditures for imports and for military and economic aid to other Arab nations and friendly developing countries -- invest them in the OECD nations and in developing countries, there can be no difficulty in the aggregate (on the assumption of perfectly operating capital markets). With surplus OPEC funds fully spent on investment abroad, there will be a slight excess of ex ante investment in the OECD nations over saving, leading in time to higher levels of output. In other words, real incomes in the OECD nations will be lower than they would have

been in the absence of the OPEC cartel but total output, and hence employment, will eventually be higher, all other things being equal. Thus, so long as the OPEC countries invest their surplus funds abroad, those commentators who worry that lower consumption in the OECD nations as a group resulting from high oil prices per se will transform the current recession into a world depression are missing the point.

The recycling problem is also now perceived as likely to be more manageable than originally feared. Instead of reaching \$650 billion by 1980 and \$1,200 billion by 1985, as previously envisaged by many commentators, the accumulated OPEC surplus will probably be in the range of \$200 to \$300 billion by 1980.^{2/} Although part of the difference between the two estimates results from the fact that the former is calculated in current dollars and the latter in constant dollars, the reduction also reflects the projection of substantially larger imports by the OPEC countries over the medium term based on the preliminary trade figures for 1974 now becoming available. Moreover, the recycling of the surplus OPEC funds has proceeded quite smoothly in the aggregate without the international financial collapse that many commentators were predicting last year. True, it is possible that some banks, especially in the Eurocurrency market, may have made excessive or imprudent loans that could be in default owing to recessionary conditions. But, it is highly unlikely that the national monetary authorities of the OECD countries will permit bank failures on a panic-inducing scale. Nor is it probable that the capital markets of the OECD countries will be unable to handle the volume of surplus OPEC funds now projected as

^{2/} See, among others, Hollis B. Chenery, "Restructuring the World Economy", Foreign Affairs, Vol. 53, No. 2, January 1975, pp. 242-263; and Thomas D. Willett, "The Oil Transfer Problem", Department of the Treasury News, January 30, 1975.

likely to be invested through them. For, if the demand for short-term loans is insufficient to accommodate the short-term lending preference hitherto manifested by OPEC monetary authorities, the resulting decline in short-term interest rates will increase their incentive to invest more funds at longer term -- a shift that in any event they have intended to make but could not accomplish quickly because of the planning and negotiating lags inevitably involved. This move into longer-term funding will involve both direct and portfolio investments, including loans to OECD governments and public authorities.

For these reasons, the recycling problem has been and will probably continue to be one for particular countries -- that is, for those OECD and developing nations that cannot attract sufficient surplus OPEC funds or their equivalent to offset their trade deficits because investment in them is regarded as unremunerative or too risky economically or politically. For Italy, the United Kingdom, perhaps France and some of the smaller OECD nations, as well as for many developing countries, the need is to induce the surplus OPEC nations to invest in them directly and, to the extent that they don't on an adequate scale, then through the financial intermediation of the International Monetary Fund, the World Bank and other international organizations. Chapter II explores in some detail the possible economic and political repercussions of the inability of deficit OECD countries to obtain sufficient recycled funds directly or indirectly and the extraordinary measures that may have to be taken to assist them.

Assuming that the transfer and recycling problems can be more or less effectively handled, the economic outlook for the OECD nations as

a group -- and hence for all countries involved in the international market system -- will be largely determined by the future course of the current recession. As explained in the Appendix, past policy decisions and recent economic developments make it virtually inevitable that the recessionary trend in the United States and other OECD nations will persist in greater or lesser degree at least until the second half of 1975. The recession in the OECD nations, and notably in the United States, is already more severe than any experienced since World War II. The danger is that the complexities and ambivalences of macroeconomic policy making in the period of the new nationalism will prove too difficult for political leaders and other policy makers to overcome. In the United States, for example, they must reconcile the adoption of rapid and substantial antirecessionary measures with the need to avoid setting off a new wave of inflation after the recovery is under way and with the implementation of policies for energy conservation and new energy development that could increase unemployment and prices. Moreover, so long as the synchronization of macroeconomic trends persists among the OECD nations, there is danger that inadequate countercyclical measures could drastically reduce international trade or that unilateral efforts to increase employment and exports by protectionist or discriminatory means could provoke retaliatory actions -- either or both of which could set off adverse positive feedback effects on the economies of the OECD nations. Such vicious circles -- rather than any effects of the oil price increase per se -- could bring within the limits of the possible the transformation of the current recession into a world depression analogous to that of the 1930s.

Nevertheless, the probability is very substantially greater that the

OECD nations will be able to avoid so catastrophic an outcome.^{8/} True, relatively high rates of inflation will persist. By mid-1975, however, there is a reasonable probability in the United States that inventory decumulation and restricted consumer demand will result in a significant drop in its rate of inflation. Thereafter, tax cuts and lower interest rates should induce rises in consumer spending and housing starts, with an upturn in the U.S. economy around the end of the year even though unemployment remains high. Economic recovery will probably be experienced in other OECD nations in the course of 1975 but there may be some significant exceptions as explained in Chapter II.

The petroleum price rise and the recession in the OECD nations have serious effects on many developing countries, especially on those in Southern Asia and tropical Africa that have been designated as the "most severely affected" (the MSAs). However, many nations in this category, particularly in Africa, are protected against socioeconomic disaster by the fact that the great bulk of their people still live in, or can return temporarily to, the traditional subsistence economy -- although, as in the Sahel, natural disasters can lead to critical situations. But, mass-population nations, such as India, have neither the ultimate reinsurance of a subsistence economy capable of sustaining increased numbers of people even temporarily nor the reserves for offsetting the adverse effects of inadequate foreign-exchange earnings or of unfavorable weather conditions. At the same time, the inward orientation characteristic of the new nationalism and the pressure to use available resources for coping with their own internal and external problems

^{8/} The reasons for this conclusion are persuasively presented by Harold van B. Cleveland and W.H. Bruce Brittain in "A World Depression?", Foreign Affairs, Vol 53, No. 2, January 1975, pp. 223-241.

make the OECD nations unwilling to increase the volume of aid of various types provided to developing countries. Indeed, relative to their total resources, some OECD nations -- especially the United States -- have significantly reduced their aid in recent years, and the real value of the existing flow is diminished by inflation. Except for temporary programs to deal with famine situations, it seems unlikely that the present trend in aid to developing nations will be reversed: at best, the probable increase in aid from the OPEC countries would offset the decline in the real value of assistance from the OECD nations.

The Limits of U.S. Policy in
the Period of the New Nationalism

The limits of the possible for the foreign policies of the United States in the years ahead will be determined by the interactions between the characteristics of the international system in the current period, as sketched in this chapter, and the changes likely to occur in U.S. domestic capabilities and attitudes.

The United States has by now experienced a decade of internal strains and frustrations -- the upheavals of minority groups, the disaffection of the young, the conflicts over U.S. involvement in the Indochina War, the great inflation, the energy crisis, the trauma of the Watergate affair, the resignation of the President, and the current recession. In one sense, these events express serious social divisions, the weakening of traditional values and behavioral norms, and the loss of national morale. In another sense, however, the ability of American society generally and of its political system in particular to continue to function effectively under the recurrent shocks of these developments -- which the corresponding institutions of some other Western societies would probably not have been able

to survive -- demonstrates that American institutions, values and norms of behavior can still adapt themselves to changing pressures and needs. Moreover, as the response of the American people to the world energy crisis of 1973-74 showed, they can unite in the face of a directly perceived major external challenge despite their domestic differences, and they can exercise self-discipline despite the substantial decline of public trust in presidential credibility and leadership. Thus, the domestic institutional and attitudinal base for the international position of the United States as a superpower is fundamentally unimpaired.

Nevertheless, the strains of the past ten years have significantly altered the conception of opinion leaders and the people generally regarding the international role of the United States. This change both reflects and has contributed importantly to the moderating of superpower relationships into competitive coexistence and to the declining ability of the United States to persuade or compel its allies and client states to take actions against their wills. Although a feared reversion into isolationism like that of the 1930s has not occurred, neither the people nor the great majority of opinion leaders have been willing to support the kind of activist world-transforming conception of the U.S. role and responsibilities in the international system that characterized their attitudes during the postwar period and culminated in the grand designs of the Kennedy Administration during the early 1960s. Nonetheless, the sense of mission to lead the way to a new and better world order has by no means been eradicated from the American self-image. It is significant that liberal political and opinion leaders, who have been in the forefront of those pressing for a much reduced

conception of U.S. responsibilities in the international system, have generally argued that one reason for concentrating national attention and resources on the solution of domestic problems is to eliminate the defects of American society and thereby make it once again a model -- "a City upon a Hill" -- to which the rest of the world can aspire.

Is it likely that this passive formulation of the American sense of mission, which has prevailed for most of our history, would in the foreseeable future again shift to an active mode, as during the two decades of the postwar period? In view of the inward orientation and domestic constraints of the new nationalism and the relative decline in the determinative power of the United States vis-à-vis other nations, a return to the missionary zeal and global interventions of the postwar years seems unlikely. However, domestic developments -- as well as international problems -- in the years ahead could lead to a significantly greater willingness on the part of American opinion leaders and the public generally to support a more active U.S. role and a corresponding expansion of "U.S. responsibilities than they manifested in the late 1960s and early 1970s. Indeed, such a change is already foreshadowed by elite-group and popular acquiescence in the reassertion of U.S. international leadership that has been becoming increasingly evident since the Arab-Israeli War of 1973 and the subsequent world energy crisis.

Assuming that there is a convincing upturn in the U.S. economy by the end of 1975, national morale is bound to revive substantially in 1976, which will be an unusually stimulative year in view both of the bicentennial celebration and of the presidential election. The bicenten-

nial celebration will undoubtedly revive a stronger sense of national accomplishment and a more positive and benign national self-image than has prevailed since the mid-1960s. These self-conceptions will be enhanced by the exigencies of campaign politics, which are likely to impel both presidential candidates to propose programs for "getting America moving again" after the long stagnation and frustration of the preceding ten years. In turn, this stimulation of national morale and sense of momentum toward positive national goals will have an ambivalent effect on attitudes toward the international relations of the United States during the remainder of the 1970s.

On the one hand, opinion-leader and popular support for a more active pursuit of international objectives will probably prevail over the reductionist and largely self-protective tendencies of the late 1960s and early 1970s. But, on the other hand, in accordance with the characteristics of the new nationalism, domestic attitudes and pressures will continue to limit the extent to which U.S. foreign policy makers can forgo actual or potential benefits or incur increased costs in endeavoring to achieve system-reforming goals. Thus, the probable domestic changes are likely to permit a more active U.S. international role but at the same time to make it more directly and immediately self-interested than it was during the postwar period.

This ambivalence reflecting domestic attitudes, moreover, will coincide with and be reinforced by that arising from the nature of the international system in the current period, as sketched in this chapter. On the one hand, the continuing preeminence of the superpowers and the likelihood of recurrent political and economic difficulties in the international system will impel the United States to active involvement

In worldwide and regional affairs. On the other hand, the "nationalization" of the international system and the decline in the determinative power of the superpowers will limit the extent to which U.S. conceptions and interests can be made to prevail. The interactions of these opposing tendencies will permit the United States to provide leadership and resources for coping with international problems but its efforts will not be on a scale comparable to those of the postwar period nor will they help to bring about system-transforming changes of similar magnitude.

Within the limits of the possible for U.S. policy as set by these general international and domestic constraints, the chapters that follow explore the specific implications for the United States of the more and the less probable courses of development during the remainder of the 1970s in two important regions -- Western Europe and the Northwest Indian-Ocean area. Prescriptive suggestions regarding other regional or functional problems likely to confront the United States in the international system are outside the assigned scope of this study. Nevertheless, because of its relevance to the future relationships between, and the international positions of, the United States and Western Europe, a comment needs to be made on the general response of the OECD nations to the rising demand of the developing countries for a new and more equitable international economic order.

The success of the OPEC nations in bringing about a significant redistribution of world income in their favor has strongly encouraged other raw-material producing countries in Asia, Africa and Latin America to try to emulate their example by the same or analogous means. Yet, in the medium term, there are few, if any, natural products for which supply/demand conditions are likely to permit long-continuing monopoly pricing

or, if they do, for which such a shift in the terms of trade would have anywhere near as substantial an impact on the real incomes of the OECD nations as the OPEC increase in petroleum prices. The unlikelihood of other "OPECs", however, is not a sufficient reason for rebuffing the demands of the developing countries. The terms of trade have been unfavorable for raw-material exporters in a large majority of the years since World War II; hence, there is justification for their claim that the distribution of world income has been too inequitable to them. Although the current domestic and international constraints of the OECD nations make this essentially moral argument of even less weight to them than it might have been in previous years, it is buttressed today by a more directly self-interested consideration than would have been the case earlier. This is the likelihood that continued frustration of the expectations of developing countries will lead to psychopolitical reactions both within them and in their external relations that will be conducive to international conflicts adversely affecting the OECD nations. For these reasons, a more sympathetic and imaginative approach by the United States is needed to international commodity arrangements and other aspects of trade, monetary and investment relations that would enable developing countries to limit the loss in their real incomes during periods of recession and gradually to increase their shares of total world income while agreeing not to push prices up excessively during periods of boom.

In conclusion, the importance must be stressed of understanding as clearly as possible the highly complex, interrelated and ambivalent nature of the international system in the period of the new nationalism and the resulting narrower limits of the possible for U.S. policy making.

In the postwar period, when the political and economic power of the United States was disproportionately great and reconstruction of the international system was the urgent necessity, American policy could be effective despite often inadequate understanding of difficulties and generally unrealistic expectations of achievement. In the current period, the relative decline of American power and the stronger constraints of domestic pressures make the consequences of perceptual and conceptual deficiencies much more serious. If -- as the old maxim goes -- "knowledge is power", it is more than ever so today.

CHAPTER II

PROBLEMS AND PROSPECTS OF WESTERN EUROPE

Not since the second half of the 1940s has the outlook for Western Europe been as uncertain as it is for the second half of the 1970s. Today, a generation after World War II, it is difficult for younger people to imagine and even for older people to recall the deep anxieties about Western Europe's future that dominated the immediate postwar years. A quarter century of peace, military security and political stability, of unprecedented economic growth and improved living standards, and of rising self-confidence and national morale separate the two periods, obscuring the seemingly intractable problems and the sense of helplessness and hopelessness that pervaded the earlier one. Yet, there are both significant parallels and important differences in Western Europe's situation then and now that provide some useful indications of the more and the less likely courses of development in the years to come.

Today, Western Europe's ability to defend itself (that is, without direct U.S. participation) against a likely aggressor is not significantly greater than it was in the late 1940s -- indeed, it may now be less because the United Kingdom is no longer a major world military power as it was immediately after World War II. Currently, three of Western Europe's biggest nations (France, Italy and the United Kingdom) and several of its smaller countries have balance-of-payments deficits of such magnitude that, if their economic conditions do not soon improve, extraordinary measures will be required to assist them that would be analogous to the U.S. aid programs of

the immediate postwar years. At present, many West European political regimes are minority parties, or have only slender majorities, or are insecure coalitions; and in their narrowly constricted scope for policy initiatives, drift toward doctrinaire immobilities, and internal factionalism, some of them are strikingly reminiscent of the then-called "caretaker" governments of the late 1940s. And, perhaps most serious of all, the élan, self-confidence and faith in the future generated by the economic prosperity and the sense of an emerging European identity and major role in the world that were developed during the late 1950s and the 1960s are today being undermined by economic difficulties, political uncertainties and the stagnation of the European unification movement -- just as morale in the earlier period had been shattered by Europe's political failures and economic catastrophes during the 1930s and World War II.

The differences between Western Europe in the second half of the 1940s and today are highly significant, too. Characteristics of the earlier period that are absent today were the universal prestige enjoyed by the United States in Western Europe after World War II and its willingness and ability to exercise leadership and provide large-scale resources for European recovery; the perception of the Soviet Union generated by the Berlin blockade and the Korean War as a frighteningly imminent external menace compelling unity of action by the West European nations; and the innovative and imaginative European

political leaders who sooner or later broke the political deadlocks of the immediate postwar years but who by now have been replaced by uninspiring if competent technocrats, cautious politicians and doctrinaire or self-interested factional chiefs. Conversely, the physical destruction, economic disorganization and near subsistence levels of living of the immediate postwar years were out of all comparison with Western Europe's present economic productiveness and high living standards. Also, the earlier period lacked the knowledge and skills and the domestic and transnational private and governmental institutions that exist today in Western Europe. Finally, the inherited national antagonisms still haunting Western Europe in the wake of the War have by now certainly receded into latency and may perhaps even have been dispelled.

Against the background of these historical similarities and differences, this chapter first assesses the problems and prospects of the four leading West European nations individually and of the European Community, and then analyzes the difficulties likely to arise in transatlantic relations during the remainder of the 1970s and the implications for U.S. policies.

Internal Developments

The repercussions of the oil embargo, the quadrupling of petroleum prices, and the severest recession since World War II have more profoundly shaken the nations of Western Europe, both individually and collectively through their membership in the European Community, than any events since the start of the cold war in the late 1940s. For, they have revealed the persistence in certain West European countries of major social discontinuities

and strains that have not been eradicated but rather have been concealed or held in check by the rising prosperity of the past 20 years. Economic developments adversely affecting these nations could intensify their underlying tensions, which would in turn exacerbate their economic difficulties. Very soon, these mutually reinforcing interactions could bring within the limits of the possible the kinds of severe political crises in these countries that have generally been regarded as unimaginable since the success of the Marshall Plan in the early 1950s. However, those who feared that such developments would make 1974 a year of catastrophe have clearly been premature. So far, except for Italy, balance-of-payments deficits have been manageable, the recycling of the surplus foreign-exchange earnings of the OPEC countries has proceeded relatively smoothly, and the recessionary trend has not involved unacceptably large increases in unemployment. But, there is a significant probability -- although by no means a certainty -- that sufficiently serious economic difficulties could develop in the next two or three years that, unless timely counter-measures were undertaken, would lead to critical political situations in three large West European nations, as well as in several small countries.

The basic interactions between economic and political trends in Western Europe, however, would not be those postulated by the Marxists, i.e., that the internal contradictions of the capitalist system impoverish the great mass of the people and lead to its eventual overthrow. Rather, they would exemplify the profound insight of Alexis de Tocqueville noted in Chapter I as a characteristic of today's new nationalism. During a period of continuing economic, political or other sociocultural improvement in the condition of the people, the progress achieved gradually generates expectations of greater and faster gains which, if frustrated by the

resistance or incompetence of the ruling elites or by adverse developments beyond their control, may shift popular support to extremist parties or politicians. In a general sense, the de Tocqueville effect would explain both the growing strength of left-wing parties and groups during the 1960s, even though living standards were rising, and the political difficulties that could occur during the remainder of the 1970s. If unemployment were to increase substantially and real incomes to decline significantly. The course of events would undoubtedly be different in each West European nation, reflecting its own distinctive economic, political and psychocultural characteristics. The following sections briefly analyze the factors involved and project the more and the less probable developments within the four largest countries and in the European Community as a whole.

Italy

The West European nation in which severe economic problems and serious sociopolitical difficulties are most imminent is Italy.

From the late 1940s until the late 1960s, the Italian economy enjoyed one of the highest growth rates among the OECD countries. Its export performance was outstanding; its balance-of-payments position was strong, except for a brief period in the early 1960s; and its monetary reserves increased substantially. In consequence, living standards rose steadily, albeit more rapidly in the dynamic industrialized north than in the traditionalistic agrarian south. This difference both reflected and stimulated the large-scale migration of workers and their families from the region south of Rome to the capital and the labor-hungry industries of Lombardy and Piedmont.

In marked contrast to Italy's economic progress were the failures of the Italian political system to overcome its inherited particularism and personalism and of the Italian administrative system to improve the efficiency of its institutional arrangements and to acquire modern managerial and technical skills. Except for the communists, the main political parties have continued to consist of agglomerations of competing factions, which are headed by rival personalities, divided by subtle ideological differences, and preoccupied with the distribution of offices, patronage and prestige. In turn, most members of the greatly overstaffed civil service have owed their appointments to their political patrons and have little, if any, specialized training or technical skills even in the higher-level, policy-making positions. Since the restoration of democratic institutions after World War II, Italy's governments have been coalitions centered on the Christian Democratic Party but shaded slightly to the right or the left depending on which of the latter's factional leaders was the prime minister and whether or not the Socialist Party participated. And, as the problems with which they have tried to deal have multiplied and intensified, successive coalition governments have become shorter-lived.

Both the stagnation of the political and administrative systems and the progress of the economy are characteristics of the present state of development of Italian national society. Italians have an historically long and very strongly rooted sense of their distinctive cultural identity but their society has had the form of a nation-state for only a little more than a hundred years. Moreover, the institutions and behavioral norms of the Italian nation-state did not evolve gradually

through long centuries of consolidation and development of an increasingly centralized dynastic kingdom from a loose medieval feudal monarchy, as did those of most other contemporary European nation-states. When Italy's small, separate and diverse political entities were unified in the mid-19th century, the Kingdom of Sardinia, the leading state, was not predominant in size or wealth over the others -- in contrast to German unification, in which the institutional structure and behavioral norms of disproportionately larger and more powerful, and already centralized, Prussia were imposed on the rest. Finally, like all south and central European countries, Italy has had only a relatively brief and intermittent experience of democratic government. The democratic institutions of its medieval city-states had withered or been suppressed 500 years ago, and thereafter it lived under the despotic rule of Spanish and Austrian conquerors and native secular and papal princes until the adoption of parliamentary government during the second half of the 19th century.

However, although authoritarian, the regimes imposed by foreign and native rulers were never as controlling or effective as those of contemporary totalitarian states. During half a millennium of relatively mild despotic rule, Italians became adept at protecting and advancing their private interests both within the rather broad interstices of governmental regulation and censorship and by means of bribery, evasion and patronal influence. These deeply rooted behavioral norms persisted after unification; indeed, they have been continuously sustained by the need to cope with the inefficiencies of parliamentary governments before World War I and after World War II and with the attempt at totalitarian

rule under the Fascist regime of the interwar period. One consequence significant for present and prospective problems is that most Italians are more or less willing and able to keep their immediately important micro social units (e.g., their families, farms, businesses, interest-group organizations, etc.) functioning by one means or another despite the serious difficulties of their macro society as a whole.

Another significant consequence has been that, in periods when conditions are conducive to rapid economic growth, Italians are capable of and eager to take advantage of the opportunities involved. In such periods, entrepreneurial dynamism and technological ingenuity have been marked. At the same time, in keeping with the traditionalistic character of Italian society, family firms have continued to be important and, even after large modern-type corporations developed, they have tended to be dominated by prepotent personalities and interrelated by the affective ties of family and local-patronal loyalties. These characteristics of Italian business enterprise have been shared even by the increasingly important state-owned corporations originally established by the Fascist regime or developed from the bankrupt private businesses taken over by the government during and since the great depression of the 1930s.

In the 19th century, economic development began earlier and moved ahead more rapidly in the north, which had long been the most economically advanced portion of the peninsula, than in the south, which remained predominantly agrarian. The rapid economic growth from the late 1940s to the late 1960s largely reflected the high level of capital investment, the enormous gains in productivity resulting from the massive shift of labor from agrarian to industrial activities, and the increasing demand

generated by rising domestic incomes and the competitiveness of exports. In the late '60s and early '70s, however, the economy faltered under the impact of the social pressures of the new nationalism explained in Chapter I. Production was cut by prolonged strikes as industrial workers, many of them recent emigrants from the backward south, sought large wage increases and other benefits to accelerate improvements in their living standards. At the same time, demands for greater social welfare benefits, increased aid to farmers, expansion of educational and health facilities, urban redevelopments, and other public investments and services swelled the expenditures of the central and local governments, with resulting large budgetary deficits, expansion of the money supply, and rising inflationary pressures.

Even so, the policy-making and administrative deficiencies of the political system meant that such public-sector investments and reform measures were generally too small and too long delayed to satisfy popular expectations for improvements in living standards in addition to those made possible by increased personal incomes. In these circumstances, the gradual growth of electoral support for the communists and other left-wing groups during the 1960s and early 1970s was not so much a reflection of positive commitment to their goals as an expression of dissatisfaction with the ruling centrist coalition, and especially its dominant member, the Christian Democratic Party.

Then, in the winter of 1973-74, the quadrupling of the price of imported petroleum superimposed on the world commodity price boom greatly magnified the internally generated inflationary pressures, turned the terms of trade substantially against Italy, and stimulated capital flight.

The result was that Italy's current-account deficit rose from \$2.5 billion in 1973 (after a surplus of \$2 billion in 1972) to an estimated \$8.5 billion in 1974, reflecting a trade deficit of over \$11 billion, of which two-thirds was on petroleum account. To cope with this massive deficit, the Italian government drew down its monetary reserves, allowed the lira exchange rate to decline, borrowed large sums in the Eurocurrency market, and resorted to the credit facilities of the IMF on a substantial scale. Imports were discouraged by various means and, in June 1974, the government was finally compelled to adopt fiscal and monetary measures of unprecedented restrictiveness. Even so, Italy -- with official external debt then in excess of \$12 billion -- had by mid-1974 exhausted its ability to borrow in the Eurocurrency and New York capital markets, and turned to the German government in September 1974 for a \$2 billion loan on the security of a portion of its gold reserve. In 1975 and subsequent years, Italy will have to rely mainly upon credit from other governments and from international organizations if its current-account deficit continues to be beyond its own capacity to finance.

In strictly economic terms, Italy has an as yet only partially developed economy that has good prospects for continued rapid growth and rising real incomes. All other things being equal, the economy has a propensity for high rates of capital investment and technological innovation, and there still are large increases in productivity to be achieved by further substantial shifts of labor out of inefficient agrarian activities, especially in the south. So long as these factors can operate freely to maintain big annual productivity gains, the economy is -- or, at any rate, has been -- able to sustain the inflationary effects of

large budgetary deficits -- amounting in some years to over 8 percent of GNP -- and rapidly rising wages without adverse effects on the competitiveness of exports and the balance of payments. However, when external economic developments or internal socioeconomic pressures or both put severe strains on the economy, the resulting problems are very difficult for Italy to meet. During the 1950s and '60s, when world trade was growing at an increasing rate and Italy's terms of trade were generally favorable, very little macroeconomic management was required of the Italian government, which simply had to refrain from impeding too much the naturally expansive forces of the economy. But, today and for the foreseeable future, the effects of recessionary trends on world trade and the large adverse shift in Italy's trade balance caused by the oil price increase magnify the difficulties generated by internal inflationary pressures. If this combination leads to persisting large current-account deficits, the Italian government will have to resort to even more restrictive measures than those instituted in mid-1974.

In essence, the disparity between the capabilities of Italy's economic system and those of its political and administrative systems defines the limits of the possible economic and political developments that Italy could be experiencing during the remainder of the 1970s. The kinds of changes needed to transform the political and administrative systems have been identified by some Italian observers as likely to be stimulated by the vigorous initiatives that have occurred at local and regional governmental levels in recent years to overcome difficulties with which the central government has failed to cope through neglect or inefficiency. It is certainly possible that these efforts -- or other analogous developments --

could transform the national political parties from below, reducing the particularistic immobilities of Italy's political system and improving the central government's administrative capabilities. But, such changes require considerable time to manifest themselves sufficiently to bring about these results. Thus, the basic question is whether Italy's economy can resume its previous role of sustaining reasonable social stability while such long-term changes are taking place in its political and administrative systems.

The favorable limit of the possible during the remainder of the 1970s would be that world economic conditions would permit sufficient growth in the value of Italian exports to keep its current-account deficits to a manageable size, i.e., that could be covered by credits from the IMF and borrowing in the Eurocurrency and other private capital markets. But, under these conditions, the need to prevent the Italian economy from being significantly more inflated than its major trading partners would probably require continuation of restrictive measures likely to involve a slower rate of economic growth and higher unemployment than were customary during the past 20 years. Even in such favorable possible circumstances, therefore, the frustration of popular expectations for rising living standards and socioeconomic reforms would continue to sustain the gradual drift of electoral support to the left that has long been evident in Italian politics. And, this leftward movement would be accelerated in proportion as world economic trends and the state of the Italian economy approached the unfavorable limit of the possible: unmanageably large payments deficits necessitating extraordinary credits from other governments and international organizations. For, such assistance would probably be conditioned on the

imposition of stringent restrictive measures that would result in little, or even no, economic growth and persisting high unemployment. In turn, the more or less widespread loss of real income would rapidly erode support for the centrist coalition.

Thus, at either limit of the possible for economic developments, serious political difficulties are likely to lie ahead. In the best of possible circumstances, the continuing drift to the left may not reach critical proportions until the early 1980s; in the worst, the political consequences would become manifest much sooner -- within the next two or three years. And, regardless of whether they emerged at a slower or faster rate, the probable political repercussions of greater or lesser economic constraints in turn would make the task of coping with economic problems more difficult and the results of governmental efforts even less effective than they might otherwise be, granted the limitations of the administrative system. Prolonged strikes and slow-downs, inadequate capital investment and capital flight, and general loss of managerial and employee morale will lead to more severe unemployment and less tractable balance-of-payments deficits than might otherwise occur. These mutually reinforcing interactions between adverse economic and political developments imply major uncertainties for Italy over the medium term. Within the limits of the possible, there appear to be three more or less likely political outcomes.

One is that the growing paralysis of the political system would lead to a right-wing authoritarian regime of some kind either by a coup or -- much less likely -- through an election. As to the latter, it is difficult to envision the emergence of a neofascist ideological appeal

capable of winning enough votes to bring such a party or coalition to office in the foreseeable future. Even in the days of Mussolini, promises of national regeneration and imperial destiny were regarded cynically or only half believed by most Italians, and motivating self-conceptions of this type are far less credible today after the major international and internal changes since the fall of the Fascist regime a generation ago. But, if a neofascist electoral victory has a low probability, the seizure of power by military officers, with or without active participation by neofascist, monarchist or other right-wing civilian groups, does not. As noted above, democratic institutions are neither long nor deeply rooted in Italian society. Such a coup could be triggered by the conspicuous failure of the present parliamentary regime to deal with rapidly worsening economic conditions and labor unrest, or by fear that the communists would dominate an existing or prospective popular-front government. To stay in power, let alone to cope with the severe economic problems that brought it there, a dictatorship would have to become increasingly repressive, exiling or imprisoning the leaders of dissenting groups and organizations, suppressing political parties, and breaking up strikes and demonstrations by force.

The second possible course of events is the election of a popular-front type of government, which the Italian Communist Party would gradually be able to control and eventually to supersede. This is a classic communist strategy which, in one variant or another, has been employed whenever the Communists believe either that events are moving in a direction favorable for them but have not yet led to a revolutionary situation, or that it is necessary to join with the democratic parties to try to prevent a right-wing authoritarian regime. Either or both

conditions could arise in Italy in the next few years, thereby increasing the likelihood that the Communist Party would endeavor to follow this strategy. However, there are countervailing considerations. One is the existence of New-Left groups that have split off from or rejected the Communist Party because of its presumed class-collaborationist or nonrevolutionary character and which would be unwilling for this reason to join it in a popular front. Another is the wariness of the Socialist Party about collaborating too closely at the national level with the Communists in view of the latter's disproportionate electoral strength and organizational effectiveness. Hence, there is only a moderate probability that the Italian Communist Party would be able to find sufficient left-of-center allies to form a plausible popular-front coalition.

The third possibility is that the democratic parliamentary government will be able to maintain itself for the remainder of the 1970s. But, to do so under either limit of the possible for economic conditions projected above, the centrist coalition is likely sooner or later to be impelled to arrest increasing popular disaffections by a further "opening to the left." As the New-Left groups are unlikely to participate -- and, in any event, would not add much strength -- the accretion of support could only come from the Communist Party. The most likely form that such support would take initially would be an agreement to provide enough Communist votes to assure the necessary parliamentary backing for a program that included the essential restrictive economic measures sought by the Christian-Democratic Party and the minimum social reforms demanded by the Communist Party. Whether an arrangement of this kind would in time

lead to Communist participation in the cabinet would depend upon whether, in the then-existing situation, the Communist Party concluded that it could thereby strengthen its popular support and political prospects and the Christian-Democratic Party was convinced that there was no other alternative to either a popular-front regime or a right-wing dictatorship.

The Italian Communist Party has been for many years the most ideologically flexible and the least subservient to the Soviet Union of the West European parties. Moreover, because the Italian political system is less efficiently centralized than those of other West European nations, the Italian Communist Party has had more practical experience of significant governmental responsibilities than the others through its control of important municipalities, such as Bologna. These pragmatic characteristics predispose it to playing the role projected above. And, it has begun to sound out the possibility of doing so, including even public assurance to Italy's present and prospective aid-givers, Germany and the United States, that it would not insist upon Italy's leaving NATO or withdrawal of the American bases. For its part, the Christian-Democratic Party is divided on this possibility and has hitherto rejected it. Although the Party's liberal factions have hinted at such an arrangement with the Communists since the difficulties of the late 1960s, the larger center and conservative factions are still strongly opposed. Most of the conservatives would undoubtedly prefer a right-wing dictatorship to an arrangement with the Communists but, if forced to make a choice, most -- if not all -- of the center factions

would probably go along with the further opening to the left. While recognizing the risk that the Communists would use every opportunity to increase their power, a majority of the Christian-Democratic factions would be likely to conclude that, in the traditionalistic intricacies of Italian politics, they would have enough experience and skill to outmaneuver their rivals, especially with the ultimate protection of a military dictatorship to fall back upon.

In sum, the economic and political outlook for Italy is highly uncertain. The more difficult its economic problems and the more stringent the measures required to deal with them, the more likely it will be that the existing democratic regime will either have to accept Communist support or be superseded by a right-wing -- probably a military -- dictatorship. The election of a left-of-center popular-front government seems significantly less probable and the election of a neofascist regime very unlikely. Thus, due to the deficiencies of its national political and administrative systems, Italy's fate during the remainder of the 1970s will be largely determined by the condition of its economic system.

France

As in Italy, the essence of the problem that France would face if severe economic difficulties were to occur is institutional. But, whereas in Italy the institutional problem arises specifically from the serious lag in political and administrative development behind the growth potentialities of the economy, the institutional difficulty in France is generalized and diffused throughout the society. It consists of the per-

sisting rigidities in French social structure and the associated antagonisms and discontinuities in the interrelationships of the main social groups.

Even more so than the Italian economy has the French economy been transformed since World War II. But, again, there is an important difference between the two nations. Whereas in Italy economic growth and modernization have been owed much more to the dynamism and mobility of businessmen and workers than to deliberate governmental efforts, the reverse has been the case in France. Since an active and directive governmental role was institutionalized by Colbert in the 17th century, the French economy has always depended upon official initiative, guidance, regulation, and assistance. Indeed, the relationship between the national government and the private sector in France has been closer and more extensive than anywhere else in Western Europe. If the Italian economy grew at night while the government slept -- as the Brazilians used to say about their own country -- the French economy grew during the day while the government actively planned, directed, threatened, and cajoled.

Moreover, in the years after World War II, the French government became increasingly able to play this role owing in large part to the capabilities of France's civil servants. Always among Europe's best educated, the French civil service has been further improved since the War as the "grandes écoles" have provided it with growing numbers of graduates specifically trained for economic policy-making and administrative responsibilities. This powerful elite group of younger government officials and technicians has been thoroughly imbued with technocratic

ways of thinking and acting, which underlie their faith in rational planning and strengthen their self-confidence and collective morale.^{1/} Both the recovery of the French economy under the weak coalition governments of the Fourth Republic during the 1950s and President de Gaulle's grand initiatives in European and world politics during the 1960s would not have been possible without the managerial skills and clear sense of direction of France's technocrats. Thanks to their efforts, France has had until now one of the most productive and fastest growing economies among the OECD nations.

The postwar transformation of the French economy began in the late 1940s with Jean Monnet's original five-year plan for rebuilding and reequipping basic industries and transportation facilities. Successive five-year plans over the next two decades gradually expanded this effort to include most of French industry, especially those sectors requiring large capital investments and advanced production techniques. Commentators have usually focused attention on the quantitative, target-setting aspect of French planning; but, although providing useful guidelines, it has not been of central importance to the modernization process. Much more significant contributions to France's economic development have been made by other governmental planning and directing activities. In the large public sector, which extends into manufacturing and banking as well as including public utilities and conventional governmental operations, the technocrats have maintained a high rate of investment with resulting expansion of output and increase of productivity.

^{1/} For the historical development of technocratic attitudes, values and behavioral norms, see Geiger, The Fortunes of the West, cited, Chapter II.

With respect to the private sector, the technocrats have taken the lead in stimulating and subsidizing the consolidation of industrial firms into larger and more efficient units, the expansion of technological research and development, and the improvement of managerial capabilities and the skills of industrial workers. They have also prodded French industrialists into facing competitive challenges instead of relying on market-sharing agreements, and into operating outside both the protective barriers of the French home market and the preferential conditions they enjoyed in the former French colonies. In consequence, French industry has been able to adjust with little difficulty not only to free trade with the other members of the European Community but also to the more intensive competitive pressures and the greater uncertainties of the world market. Finally, the productivity of French agriculture has been raised significantly in those regions where terrain and soils are most conducive to the consolidation of holdings into large units and the growing use of advanced machinery, fertilizers, seeds, and methods of cultivation.

At the same time, however, there are sectors and aspects of the French economy that have not yet been touched by or have only begun to experience the modernization process. Despite the mergers and takeovers among industrial firms, many companies are still too small to obtain significant economies of scale, to carry on adequate research and development programs, and to meet effectively the competitive pressures within the Community's common market. Although well-trained technocrats are now rising to top-level, policy-making positions in the large corporations, most small and medium enterprises continue to be traditionalistic family firms lacking modern managerial and technical skills and oriented

toward operating in small-scale stable markets. A large part of French agriculture outside the dynamic regions noted above still consists of farming units too small or scattered to afford mechanization and requiring subsidies and other governmental aids to yield acceptable incomes to their cultivators. Both wholesale and retail distribution systems have lagged behind in the modernization effort and still contain a great many small, relatively inefficient enterprises. The French financial system has yet to develop private capital markets of adequate size, diversification and flexibility. Thus, despite the unprecedented modernization of important sectors of the French economy since the late 1940s, there is much that still needs to be done.

In turn, the lagging sectors of the French economy both reflect and sustain the traditional rigidities of French social structure and attitudes. France still has a peasantry on its many small, low-income farms and a large petite bourgeoisie in its numerous small businessmen, shopkeepers, service employees, and lower-level functionaries in local government agencies and old-line national government departments. Although of declining importance, the authoritarian and paternalistic patrons of the haute bourgeoisie have not yet been entirely superseded by modern professionally trained technocrats. Many skilled industrial workers, as well as large numbers of semiskilled and unskilled laborers, still think of themselves as constituting a proletariat engaged in a class struggle with the employers. These class differentiations and attitudes inherited from the 19th century have had two important consequences for France's political system that have only recently begun to change. One has been the relative stability of the popular electoral

bases of the right-wing, center and left-wing political parties.

The other has been the tendency for the disaffected groups to remain quiescent for relatively long periods as their dissatisfaction and resentment accumulated, and then to explode suddenly in unexpected mass violence often triggered by quite unrelated events (as in May 1968).

Those characteristics of the French political system are beginning to change as the modernization of the French economy progresses. As noted above, the latter has involved the steady movement of people from small, low-productivity farms, workshops and retail establishments into larger, higher-productivity agricultural, manufacturing and service activities. Although this flow is not yet on a scale sufficient to sweep away the rigid class differentiations and associated attitudes, it has made the customary support for the center parties much more fluid. That is, an increasing number of independent voters are willing to shift their support to the right or the left depending on their perception of threats to and benefits for their interests. Released from inherited political orientations, these mobile independent voters were largely responsible, on the one hand, for the 1968 Gaullist parliamentary victory in reaction against the mass violence earlier in that year and, on the other, for the near victory in 1974 of the popular-front presidential candidate in reaction against the frustration of expectations for improved living standards and social reforms under the Pompidou regime. This most recent leftward shift was also helped by the adoption of less ideologically rigid tactics by the French Communist Party, until a few years ago one of the most inflexible and subservient to Moscow of the West European

parties. (In effect, this Communist change may itself be a reflection of the gradual erosion of the old class differentiations and attitudes.) Today and for the foreseeable future, therefore, French politics is becoming increasingly fluid and volatile: there is now a growing group of independent voters whose swings will largely determine elections; at the same time, the traditional class distinctions and behavioral norms have not yet been sufficiently transformed to eliminate the likelihood of further outbreaks of mass violence.

To transform the French economy, the technocrats have maintained a high rate of capital investment in plant and equipment in both the public and the private sectors, and they have sought to increase exports to balance the costs of expanding imports and to build up monetary reserves. After de Gaulle's assumption of power, a heavy burden of expenditures for rearmament and the development of nuclear military capabilities was imposed on the economy. At the same time, economic growth has both stimulated and made possible the partial satisfaction of popular expectations for near full employment, rising consumption and improved quality of life. These official priorities and social pressures have recurrently led to capacity bottlenecks and excess demand in the French economy, which has persistently had one of the highest rates of inflation in the OECD countries. Moreover, either the superior claims of investment and military expenditures or inflation or both have in some years prevented or severely limited real increases in consumption and the financing of promised social reforms. Such developments have helped to intensify the popular discontent that could at any time well up from beneath the surface stability of French society.

Since May 1968, the technocrats -- as well as the right-wing and centrist politicians -- have been wary of a recurrence of such mass violence. Real wages were permitted to rise substantially during the boom years of the early 1970s, and measures to cope with mounting inflationary pressures in late 1973 and '74 were aimed at restraining investment rather than consumption. So long as external economic conditions are not too unfavorable, the technocrats are able to orchestrate the competing official priorities and domestic social pressures into a reasonably effective macroeconomic management policy. But, the changed world economic situation resulting from the oil price rise and the recessionary trend is now confronting them with the need for adjustments that could have serious internal economic and political repercussions.

France is currently running a large balance-of-payments deficit resulting in part from the quadrupling of the price of imported petroleum and in part from the fact that, while continuing excess demand in the French economy during 1974 pulled in increased imports of capital and consumer goods, French exports did not grow commensurately owing to the restraints imposed on domestic demand in Germany, its major trading partner. To moderate the adjustments required to cope with this deficit, France has large monetary reserves and has hitherto been able to borrow in the Euro-currency and other private capital markets and from the OPEC nations. Moreover, the French government has continued its restraints on investment, slowed the increase in the money supply, and announced a limit on the total cost of permitted petroleum imports in 1975, which -- at current prices -- would result in a 10 percent decline in consumption. There is a reasonable chance that these measures, plus the revival in German import

demand resulting from the recent easing of German fiscal and monetary policy, will enable the French government to get through the next 12 to 18 months without having to impose more severely restrictive policies than those now in effect. However, this means a significantly slower rate of economic growth than that of the past not only for the short term but, for the structural reasons explained in the Appendix, probably for the medium term as well.

This reasonably favorable projection could be nullified either by internal sociopolitical developments or by the failure of French exports to increase as much as anticipated, or by a combination of the two. Already, the French government's ability to carry out the requisite macroeconomic policy and export strategy for the short term was threatened in late 1974 by a wave of strikes for substantial wage increases in public-sector services and industries that is likely to recur in 1975 and to spread to the private sector. In turn, too slow economic growth and, above all, no economic growth will be conducive to manifestation of the De Tocqueville effect. Thus, in the short or the medium term, both the less and the more severe frustration of expectations for full employment, rising living standards and improved conditions of life is likely to lead at the least to a decisive swing of electoral support to the left and at the worst to the always possible outbreak of mass violence. And, the capacity to contain the latter may be weaker in the future than in 1968 if the current disaffection in the French armed forces persists.

France has both more and less leeway than Italy for coping with such problems. Compared to Italy, the decision-making and administrative

titles of the French government are much greater, France has larger

resources of its own, and it probably has not yet exhausted its capacity to borrow in private capital markets and from the OPEC nations. But, whereas Italy has few, if any, political and psychological inhibitions about accepting official financial assistance from other OECD countries, such recourse would be very difficult for the French government, especially if popular support for it were already weakened. Many Frenchmen -- and not only the Gaullists -- still feel humiliated by France's dependence on U.S. economic aid during the postwar years and by its continued reliance on the U.S. nuclear guarantee, and they resent the real and imagined restraints on their national freedom of action involved. These attitudes reflect the deeply rooted pride in France's historical achievements, the conviction of its continued cultural superiority, and the hope that it might one day become a great world power again. Any French government compelled by economic difficulties to accept overt, large-scale financial aid from the United States, or even from Germany, would be open to a politically effective attack by its opponents. This means that the technocrats and politicians would be likely to incur substantial risks before seeking such aid and that, if it becomes unavoidable, it should be given in ways that would enable the French government to save face domestically.

Nor is it clear that French society could bear substantially greater strains than could Italy's before reaching the danger point. As explained in the preceding section, long experience has taught the Italians to expect little from their government and to rely as much as possible on their own ingenuity and resources. In contrast, the French have been accustomed since the 17th century to a strong, active central

government that is regarded as having the main responsibility -- indeed, the sole prerogative -- for dealing with serious economic problems. Thus, the French government could be caught in the dilemma, on the one hand, of having to satisfy popular expectations for vigorous and effective remedial actions or lose popular support and, on the other, of lacking sufficient resources for doing so unless it obtains outside assistance, which could lead to mounting public criticism.

In sum, the more severe France's external economic difficulties become, the greater the likelihood that governmental measures to limit unemployment and maintain -- let alone raise -- real incomes would not be sufficiently effective and that foreign aid would have to be obtained of a magnitude that would weaken popular support for the existing regime even further. The variations in this relationship will mainly determine which of the several more or less probable courses of development France will experience during the remainder of the 1970s.

The more probable is that external economic strains will not be so serious as to preclude a sufficiently high rate of economic growth to permit continuing improvements -- albeit modest -- in popular living standards without the need to obtain foreign aid in forms and on terms that would help to undermine support for the center-right government during the remaining term of the existing legislature. In that event, it would have a good chance of emerging from the 1978 parliamentary election with a working majority. A somewhat less likely alternative is that, if economic conditions do not become too adverse, a new center-left coalition might emerge either under Giscard d'Estaing's leadership or, more likely, under that of Mitterand and the newly resurgent Socialist

Party, which would abandon its alliance with the Communist Party. With the Gaullists in opposition, either type of center-left coalition could be expected to follow somewhat stronger counterinflationary or counter-recessionary policies and marginally more reformist measures than the existing center-right government.

If, however, economic conditions become sufficiently adverse in the short or the medium term, two other courses of development would be well within the limits of the possible.

The one with the lowest probability is that economic difficulties and political unrest would be so severe that the resulting outbreak of mass violence would provoke a right-wing coup against the present center-right or a new center-left coalition. Such a dictatorship could only be imposed with military support. However, unlike in 1958 and previous military coups in French history, there is not today a General de Gaulle -- or even a Marshall Petain -- with the national prestige and the reputation for disinterested devotion to France required to provide credible leadership or even to serve as a figurehead. Nor is there a right-wing or center Gaullist politician who could plausibly play this role. This lack of leadership is an important factor weighing against giving a higher probability to the overthrow of the existing government by a military coup. Instead, the Gaullists would be likely to try to win an ensuing election by emphasizing the danger of a communist takeover, as they did so successfully in 1968.

Based on recent political trends, the more probable development would be replacement of the center-right coalition in the regular 1978

parliamentary election -- or in a special presidential or parliamentary election called before then -- by a left coalition led by the resurgent Socialist Party in alliance with the Communists. That such a coalition would be headed, at least initially, by the Socialists is presaged by the fact that, in the 1974 presidential election and subsequent parliamentary by-elections, the independent voters mostly swung to them rather than to the Communist Party.

Essentially a popular-front type of government, the new regime would have to cope with more difficult problems than its predecessor. Compelled by the circumstances of its electoral victory to satisfy popular expectations for full employment and improved living standards, it would at the same time be constrained to impose the restrictions needed to limit inflationary pressures and reduce the payments deficit to manageable proportions. Inevitably, the effort to fulfill these conflicting requirements would drive it to increasingly drastic income-redistribution measures and spreading nationalization of industry, finance and services that would generate a vicious circle of inadequate investment and capital flight, slower growth or deepening recession, and stricter internal and external controls. As economic conditions deteriorated, the Communist Party would seek to exploit popular disappointment in the regime's failures and to increase its own strength in preparation for coming to power during the anticipated outbreak of mass violence. (However, if the outbreak were to occur, it would very probably provoke a right-wing/military coup.) In any case, the Communist members of the government would be likely to press much more vigorously and quickly than they did in the Allende regime in Chile to restrict the freedom of action of opposing groups and organizations, to win the support of the already disaffected

elements in the armed forces, and to remove officers likely to oppose them. Much would depend upon the extent of the economic aid that the popular-front government could get from the Soviet Union and upon the latter's ability to deter or counteract U.S. and German efforts to weaken or undermine the regime. At the same time, the anticommunist groups and organizations would recognize that the longer they delayed acting against the government, the poorer their chances of success would be. Hence, they would endeavor to join with the anticommunist military officers in organizing a coup as soon as they could recover sufficiently from the demoralization that would follow their electoral defeat. If by then the Communists had been able to arm the trade unions and students and to replace enough of the commissioned and noncommissioned officers with supporters or sympathizers to count on a significant part of the military forces, the result would be a French analogue to the Spanish Civil War of the 1930s.

The probability of such a course of development in France is directly proportional to the severity of the economic difficulties with which the existing regime must cope. But, unlike in Italy where sufficient outside economic aid would substantially improve the chances of preserving democratic institutions, the provision of external assistance to a beleaguered French government would be likely to have ambivalent and hence uncertain effects. Therefore, although a politico-economic crisis is more imminent in Italy, severe economic difficulties would make the maintenance of democratic institutions in France equally uncertain. A military dictatorship would have to be ruthlessly repressive to maintain itself in power, and a civil war to prevent an even more repressive totalitarian communist regime would involve violence and human suffering on a scale unprecedented in modern French history.

United Kingdom

In contrast to France and Italy, the essence of the problem confronting the United Kingdom could be more accurately characterized as psychocultural rather than institutional. That is, Britain's present and prospective difficulties are rooted in recent changes in the ways of thinking and acting of its people rather than in the nature of the interrelationships among its political and economic organizations and institutional systems.

For the past thirty years, the British economy has had one of the lowest growth rates among the OECD members. But, even in the best of circumstances, its rate of economic growth would undoubtedly not have been as high as those of many continental countries because the United Kingdom had long before obtained most of the gains resulting from the transfer of people from lower- to higher-productivity activities. In addition, without either an aggressively entrepreneurial private sector like Italy's or a hard-driving technocratic central government like France's, the British economy became languid after completing its postwar reconstruction. The large public sector created by the Labour Party's nationalization of coal, steel and other industries has had rising operating and capital deficits covered by government subsidies and its productivity has grown slowly. Except for the big, multinational corporations and a minority of smaller dynamic companies, most private enterprises have been content to serve the secure, consumption-oriented domestic market, and export-led growth has occurred intermittently and briefly, in contrast to the major continuing stimulus obtained in this way by Germany, Japan and other OECD members. Moreover, the resulting relative decline in Britain's share of world exports and the surging demand for imports whenever domestic

consumption expands mean that the U.K. balance of payments is prone to move increasingly into deficit as the economic growth rate rises. In turn, this relationship has led to the British government's well-known macroeconomic policy of "stop-go," which has limited the average rates of GNP growth and capital formation and thereby helped to perpetuate the slow gain in productivity.

Underlying these growth-inhibiting institutional interrelationships are certain psychocultural changes that are the essence of Britain's current and prospective problems. Since the early 1950s, when postwar reconstruction was largely completed and after the Conservatives abolished the tight network of economic controls that the preceding Labour government had maintained, life became increasingly pleasant for all but the lowest-income groups. Although the favored groups were intent upon broadening and diversifying their consumption and improving the quality of life, important differences among them in attitudes and motivations gradually emerged over the next two decades.

With a less and less credible external menace steadily weakening the traditional British sense of national unity, British working people have felt increasingly free to focus their attention and energies on internal concerns, particularly to press for rising living standards, assured employment, and greater social-welfare benefits. And, because the economy as a whole was growing at a slow rate, these gains have been realized not only through increases in total goods and services but also through redistribution of income in favor of wages and social-welfare services and away from business profits and earnings on investments. Moreover, this shift has been occurring despite inflation, which usually redistributes

Income in favor of profits, and it is expressed in the relatively low rate of capital formation and the strong orientation of the economy toward consumption. In part, the redistribution of income has been achieved through the growth of the public sector and, in part, through the power of the trade unions, to which about half of Britain's blue- and white-collar workers belong and which have become especially strong in activities that importantly affect the operation of the economy as a whole. Today, not only do the British trade unions have greater economic and political influence than do those of any of the other major OECD countries but they also pursue economic gains for their members more single-mindedly and with less concern for the effects on the economy as a whole than is the case in most continental nations.

A subtle change in attitude underlies these developments that is impossible to measure and hard to describe precisely. It is the loss of working-class (both blue and white collar) confidence in and respect for the upper and middle classes generally, which reflects not only the workers' long-suppressed resentment against the elite groups' traditional insistence on their social and moral superiority but also the latter's own declining self-confidence and sense of mission discussed below. This change underlies and in turn is reinforced by the mutual distrust and stubborn inflexibility that make labor-management relations so unsatisfactory in many private companies and even in public-sector corporations. Hostility toward the upper- and middle-income groups is also fostered by many educators, media personnel and other opinion moulders, whose socialist preferences naturally influence the views of their students, listeners and readers. These attitudinal

developments have embittered intergroup relationships and intensified the pursuit of immediate and direct self-interests by the trade unions regardless of the consequences for other groups -- such as unorganized workers, colored immigrants, elderly pensioners, etc. -- without effective bargaining power and for the national economy as a whole.

The changing attitudes of working people both toward the upper and middle classes and regarding improvements in their own conditions of life have opened the way for communists, communist-sympathizers and militants generally to dominate more and more trade unions and local Labour Party organizations. Their increasing influence does not mean, however, that popular support for communism per se is growing significantly. Rather, it reflects recognition by union members that their determination to increase their real incomes can be more rapidly and substantially realized by uncompromising communist and militant leaders than by the kind of moderate "labor statesmen" -- as they would be called in the United States -- who led most unions during the wartime and postwar periods. Unlike in France and Italy, therefore, the growing influence of communists in the British trade unions does not reflect or imply more active and direct participation by the Communist Party in the national political system. In other words, British workers appear so far to be using the communists more successfully for their own purposes than the latter are able to use them as a means to achieving political power.

Both stimulated by and helping to foster these changes in the ways of thinking and behaving of Britain's working people are those in the self-conceptions and attitudes of many members of the upper- and middle-

income groups. The latter developments are more complex and subtle than the former and hence are more difficult to describe briefly.

One of the major elements in the attitudinal change in these groups reflects, and in turn hastens, the decline in the international power and importance of the United Kingdom. During the two postwar decades, most political and economic leaders were members of age-cohorts born and educated early in the century when Britain was still a major world power and their own superior positions within British society were questioned only by a small minority of the population. With an innate conviction of their right to make national policy -- and of the rightness of their policies -- their self-confidence was not undermined significantly even by the great depression of the 1930s, and Britain's heroic role and victory in World War II helped to sustain their sense of national mission into the cold-war period of the late 1940s and 1950s. But, by the 1960s, they were being replaced by younger political and economic leaders, whose childhood and education took place during the uncertain and doubt-instilling years of the great depression, World War II and its aftermath. Also, the changed position of the United Kingdom in the international system had by then been made dramatically clear by the Suez Crisis and the passing of Britain's "special relationship" with the United States as junior partner in managing the Western alliance. The age-cohorts reaching policy-making levels in politics and the economy since the early 1960s are no longer impelled by the conviction that the United Kingdom is and must remain a great world power. Indeed, with more or less reluctance, they have been arranging for the withdrawal of British forces from "east of Suez" and

will probably soon have to make reductions in Britain's military commitments to NATO.

Another major element has been the related tendency of many members of the upper- and middle-income groups to become preoccupied with immediate personal, family and local interests and activities. Still having sufficient means to lead a pleasant life, they were not much alarmed until recently by the redistribution of income, and many were inclined either to regard it as morally justified or to resign themselves to it as inevitable. Most deplored the lagging performance of the British economy but few were deeply disturbed by the fact that, by the 1970s, the United Kingdom had one of the lowest per capita incomes among the OECD nations. Although much intellectual energy was expended in diagnosing and prescribing for Britain's economic problems, neither Conservative nor Labour governments were ever able to break out of the expedient "stop-go" policy that the strong consumption orientation of the great majority of people in all social groups constrained them to follow.

The long golden afternoon of the British upper and middle classes is now coming to a close in the wake of the world commodity price boom, the petroleum crisis, and the current recession. As petroleum prices rose during 1974, the merchandise deficit increased to a total of over \$10 billion for that year, and the inflationary push generated by high import costs is being sustained by the wage increases forced by the trade unions and by heavy government spending for social-welfare purposes and subsidies to the nationalized industries. Hitherto, the British government has been able to limit the severity of counterinflationary monetary

and fiscal measures by borrowing abroad in the Eurocurrency and other private capital markets and from the OPEC nations. But, it now faces a major policy dilemma. On the one hand, with foreign and domestic confidence in the British economy sagging under the weight of continued high inflation and large payments deficits, it is under pressure to impose more severely restrictive measures than those in force. On the other, rising unemployment may soon impel it to the opposite course of stimulative counterrecessionary measures.

Thus, owing both to the long-term trend of lagging productivity growth and to the current international economic strains, the United Kingdom faces more difficult problems and adjustments than those with which it has had to cope since the years of austerity immediately after World War II. And, because of the attitudinal changes sketched above, neither a Conservative nor a Labour government has today and is likely to have in the foreseeable future as much freedom of action to institute necessary remedial measures as previous governments of both parties had until recently. In these circumstances, the economic and political outlook for the remainder of the 1970s is somber.

Unlike in France and Italy, democratic institutions and norms of behavior are so long and deeply rooted in the United Kingdom that a right-wing dictatorship or military coup or the coming to power of a communist regime directly or through domination of a popular-front type of government are all highly unlikely in the medium-term future. Indeed, the probability is greater that, as often before in British history, contending groups would put aside their differences in the face of the common danger of inflation and recession, and would unite in the national interest and "muddle through." Yet, in view of the psychocultural changes and the embittering of intergroup relationships that have occurred in recent years, the degree of national consensus requisite for

successfully muddling through the kinds of difficulties likely to confront Britain during the remainder of the 1970s is by no means assured. Hence, a third possibility would appear to be the most probable.

The Labour Party regime returned to office in the October 1974 election with a very slender majority is bound to be constrained by both economic exigencies and its electoral support by less than 40 percent of the voters to moderate in practice the income-redistribution and socialization measures that were proposed in its election manifesto and continue to be pressed by the Party's left wing and the trade-union militants. Nevertheless, the Parliamentary leadership will probably lack the power and prestige to restrain the trade unions from obtaining bigger and more frequent wage increases than warranted by productivity growth. At the same time, the nationalization of inefficient companies and branches of industry in order to fulfill election promises and to preserve jobs will mean that public-sector investment -- much of it subsidized by the government -- will not increase productivity proportionately. In consequence, costs and prices in the British economy are likely to continue to be significantly more inflated than those in its major trading partners. The long-term trend of inadequate capital formation will be accelerated and the present Labour government will be even less able than its predecessors to break out of the "stop-go" pattern of macroeconomic management. If the terms for the government's takeover of 51 percent of North Sea oil and the prices at which the private companies can sell their share of petroleum output are

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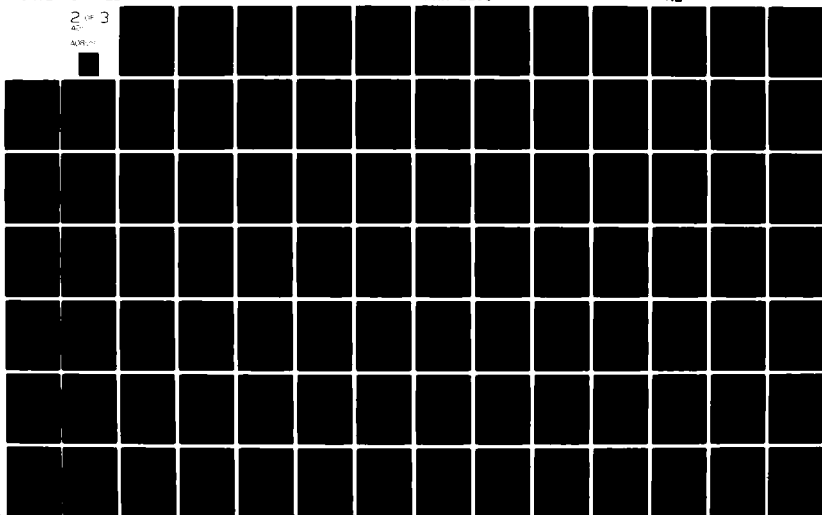
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too unfavorable, the development of this resource will be slower than planned and its contribution to easing Britain's payments problem will not be as great as anticipated. Finally, the pressures for autonomy in Scotland and Wales seem likely to become strong enough to impel the central government to make concessions that could further impair its ability to cope with the problems confronting the nation as a whole.

In these circumstances, the U.K. government and the other public-sector bodies would be unable to borrow in the Eurocurrency and other private capital markets sufficient funds to obviate the necessity for highly restrictive measures to limit import demand and domestic consumption. To avoid such severe restrictions and counteract rising unemployment, Britain will probably need aid from other governments. This dependence on the goodwill of other OECD governments would, however, reinforce the other considerations of national advantage in inducing enough people to vote in the promised referendum to retain British membership in the European Community on the basis of an apparently more favorable agreement negotiated by the Labour Party government.

In sum, the economic problems confronting the United Kingdom during the remainder of the 1970s will be more difficult to resolve than those with which it has hitherto tried to cope, and the Labour Party government will have less freedom of action to deal with them than its predecessors. These constraints both reflect and will further intensify the psychocultural trends that have been embittering class relationships and strengthening particularistic pressures to protect or advance individual

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and group interests at the expense of the effectiveness of the economy as a whole. Thus, the United Kingdom is likely to continue to drift at an accelerated pace toward an unsatisfactory kind of socialist society in which, unlike in Sweden, productivity does not grow fast enough to fulfill expectations for improved conditions of life and persisting economic problems prevent the revival of social peace.

Germany

Germany has today and will in all probability continue to have the strongest economy in Western Europe. So far, it has not been seriously affected by current international economic strains. Indeed, in 1974, it enjoyed the biggest balance-of-payments surplus since World War II; and, at nearly \$33 billion, its monetary reserves are larger than those hitherto accumulated by any other nation. It has already lent Italy \$2 billion and will undoubtedly be called upon to extend much greater assistance in the coming years to that country and some of its other partners in the European Community to help ease their economic and political difficulties. Thus, except for its lack of nuclear military capabilities, Germany is now and for the remainder of the 1970s will continue to be the strongest power in Western Europe.

Yet, even Germany has certain potentially serious internal difficulties which, as in the United Kingdom, are essentially psychocultural in nature. However, their specific characteristics are quite different from those of the United Kingdom. In Britain, the significant aspect of changes in ways of thinking and behaving is their effect on

Intergroup relationships and on the performance of the economy. In contrast, Germany's psychocultural problem is the failure so far to emerge of a new dramatic design for the nation as whole to replace the former sense of national purpose and destiny that had been weakened by the German defeat in World War I, discredited by Nazi atrocities and the German collapse in World War II, and dissolved by the division into communist and democratic political entities. For, the two incipient courses of development during the 1950s and early 1960s that could have given new meaning and sense of direction to German society have both proven to be abortive. Today, in consequence, feelings of aimlessness and self-dissatisfaction and a vague anxiety about the future pervade West German society despite -- in fact, partly because of -- the unprecedented prosperity enjoyed by virtually all of its citizens.

By the mid-1950s, the process of physical rebuilding and economic recovery had gone far enough for West Germans to begin to look beyond immediate necessities and dangers to questions of the emerging nature of their reconstructed society and of their role in Europe and the world. Under the leadership of Konrad Adenauer and the Christian Democratic Party, a dual sense of developmental direction evolved. reunification with East Germany and full participation in a gradually uniting Europe based upon Franco-German reconciliation and partnership. Although these two objectives were partly inconsistent -- i.e., a unified Germany would have been so disproportionately large and powerful as to have deterred France and other West European states from uniting with it -- they nevertheless served to revive national morale by instilling the beginnings of a new sense of national purpose among the West German people. However,

since the late 1960s, it has become increasingly clear that this vision of Germany's future destiny is unlikely to be realized. For reasons explained in a later section, the probability has steadily declined that the European Community would in the foreseeable future go much beyond the existing customs union toward meaningful political and economic unification, even though none of its members have openly abandoned that goal. At the same time, the political realities of continued Soviet hegemony in Eastern Europe and the prospect of economic advantages from a detente with its eastern neighbors induced the West German government, however reluctantly, to accept East Germany as an independent sovereign state, thereby reducing reunification from a specific national goal to a vague hope for some indefinite future.

The result has been a growing sense of national aimlessness and uncertainty that cannot be allayed by material prosperity or even by Germany's favorable economic outlook. Indeed, these benefits may only increase the difficulty in a society like Germany's that still retains inherited values and norms of behavior strongly inclining individuals and groups to subordinate their own interests to the advancement of generally shared conceptions of the nation's self-justifying reason for being and self-fulfilling destiny. Hence, the pursuit of material prosperity, on the one hand, may become perversely gross and, on the other, may generate feelings of personal guilt and social disaffection. Both phenomena became evident in Germany by the late 1960s and, in different ways, each has contributed to the gradual drift of political support away from the moderate reformist position that has long been dominant in the Social Democratic Party. On the one hand, there have

been a revival of Marxism of various New-Left types in the universities and an impatience for a drastic renovation of German society among many intellectuals and even some young workers. On the other hand, alarm over this increase in radical activism and fear that German prosperity is endangered by Social Democratic reforms and inability to cope with inflation and recession have more recently been inducing many older voters to shift their support to the Christian Democrats.

Psychocultural developments of these kinds are normally slow processes that significantly affect social institutions and relationships only over long periods of time. Hence, all other things being equal, they are not likely substantially to alter the nature of German political alignments during the remainder of the 1970s, although they undoubtedly would have a tendency toward polarizing politics at the extremes over the longer term. Nor is it likely that world economic developments will subject West Germany to economic strains severe enough to generate new institutional difficulties and social conflicts. Rather, the danger is more subtle and its ill effects would be irreversible when they eventually became apparent in the longer term. It is that the beneficent actions that Germany would be impelled to take in the next few years to assist its European partners to cope with their economic and political problems would quite inadvertently begin to fill the existing cultural vacuum with revived conceptions of Germany's national superiority and hegemonial destiny.

In other words, Germany's persisting economic strength will increase its economic importance and political influence in Western Europe both

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likely to confront Italy and the United Kingdom. But, in neither of these northern nations are the internal institutional and psychocultural strains of sufficient magnitude to be aggravated to critical proportions by such adverse economic developments. This is not the case, however, in some of the southern countries bordering on the Mediterranean. For this reason, the outlook for Portugal, Spain, Greece and Yugoslavia needs to be very briefly sketched.

The most imminent critical developments are in Portugal, whose future political orientation is likely to be determined during the current year. The termination of colonial rule has not yet lightened sufficiently the military burdens on the Portuguese economy, while the fall of the dictatorship in 1974 released internal inflationary pressures that have been compounded by the quadrupling of the price of imported petroleum. The resulting economic strains are being exacerbated not only by the current world recession but also by Portugal's political uncertainties. Portugal has had only brief interludes of democratic political rule, with the latest ending half a century ago. Owing to its nature and external connections, the Communist Party is the only comparatively well organized and financed, centrally directed, and ideologically united political group. The noncommunist parties are all inexperienced, loosely organized, poorly financed, and undecided as to goals and means of policy. In these circumstances, the Communist Party -- despite its slender popular support -- has been able to follow classical Leninist tactics, pressing for advantages against the other parties -- even those of the left with which it is ostensibly allied -- and striving to control the communications media, the trade unions, the local governmental organizations, and other centers of public and private power.

These Communist Party tactics have so far been successful due not only to the weaknesses of its rivals but also to deep ideological differences within the ruling military regime. The political outcome in Portugal, therefore, depends very largely upon how extensive the intentional and unwitting support for the Communists may be -- or may become in the next few months -- within the military regime. However, even if the noncommunist elements within the military retain control and are willing eventually to relinquish power to a civilian government, it is by no means certain that a viable democratic regime could be established, given the traditionalistic nature of Portuguese society. The inexperience, lack of clear and consistent objectives, and personal rivalries of the noncommunist parties participating in a likely center-left coalition would probably permit the Communists to influence and eventually to control the government unless a strong democratic political leader with a charismatic personality were to emerge. Thus, the alternatives to an eventual Communist-dominated regime -- and the possibility of an ensuing civil war -- would appear to be either continuation of a military dictatorship controlled by noncommunist officers or a civilian government dominated by a prepotent political leader.

In Spain, too, democratic political institutions and norms of behavior have only weak and shallow roots and have been in abeyance for over a generation. The Spanish economy has enjoyed a long period of rapid growth that has permitted living standards to rise and enabled the Franco regime to keep potential social conflicts under control. But, current international economic strains are adversely affecting the Spanish economy. In the next few years, Franco is likely to die, leaving the

successor regime to struggle without the benefit of his great prestige with increased economic difficulties and mounting pressures for political liberalization and social reform.

Nonetheless, the probability of growing communist influence and eventual communist domination is not as high in Spain as it is in Portugal. Although there is growing sentiment among younger officers for liberalization of the regime, it is unlikely that the Spanish officer corps has been as much radicalized as has Portugal's: it has not been demoralized by a long unsuccessful colonial war and its political attitudes have been more carefully watched and controlled. Hence, it is less likely than in Portugal that the senior civilian and military leaders of Spain's successor regime would be overthrown by radical young officers. And, if the army remains firmly under its control, the successor government would probably be able to maintain authoritarian rule for the remainder of the 1970s, and perhaps for longer if events in Portugal aroused fears of communism and civil war. However, the inception of a process of political liberalization and social reform by the successor regime -- particularly if undertaken during a period of low or no economic growth, high inflation and rising unemployment -- would be bound to stimulate popular expectations of faster and more far-reaching progress than the ruling elite would intend. Such a course of development could lead to collapse of the regime through mounting strikes, demonstrations and other manifestations of popular unrest unless it were willing and able to suppress them by force. Although Spain's inherited norms of behavior would not inhibit such repressive measures, however bloody and cruel, it is by no means certain that a successor authoritarian regime would be able to control the pro-

cess of liberalization and reform while democratic institutions developed sufficient strength and experience to prevent an eventual communist triumph.

Over the longer-term in both Spain and Portugal, it is possible that the noncommunist forces could be decisively strengthened through increasingly close economic and political ties with the European Community, culminating in full membership. However, this relationship is not likely to grow fast enough to preclude the kinds of adverse political developments, sketched in the foregoing paragraphs, that could occur during the remainder of the 1970s.

Another potentially serious situation could emerge in Greece before the end of the 1970s. With the recent military dictatorship destroyed by its own economic incompetence and political folly, with the nation humiliated by the resulting Turkish victory in Cyprus, and with the economy suffering from high inflation and rising unemployment, the newly reestablished democratic regime must satisfy popular expectations of economic recovery and social reform. If he can hold his large parliamentary majority together, Karamanlis has a good chance of succeeding in these tasks provided an acceptable settlement is reached in Cyprus and external economic developments are not too adverse. If he fails, popular sentiment is likely to shift strongly to the left, bringing to power a socialist-dominated coalition government with communist support and perhaps communist participation. Even if headed by a moderate like Mavros and almost certainly if led by a doctrinaire socialist like Papan-dreou, such a left-wing government would very likely be impelled to institute income-redistribution and socialization measures that would result in economic deterioration, as in Chile under the Allende regime. In these circumstances, the outcome would probably be either another

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military dictatorship or an eventual communist takeover of the government
-- In either case perhaps after a bloody civil war.

Although it is not a full member of the OECD, Yugoslavia's prospects need to be considered, for it, too, could face serious economic and political difficulties during the remainder of the 1970s. Slow or no economic growth in Western Europe means less Yugoslav exports to those countries and less credit from them to finance Yugoslavia's imports, fewer jobs for Yugoslav immigrant workers and smaller remittances from them. At the same time, the increased cost of imports, especially of petroleum, would further worsen the payments deficit and perpetuate inflationary pressures. These economic problems are likely to coincide in the next few years with Tito's retirement or death. In such circumstances, the hitherto suppressed conflict would emerge between those members of the ruling communist elite determined to maintain an independent course and those convinced of the desirability of reestablishing close ties with the Soviet Union. In turn, this struggle could aggravate the tendency toward separatism in some of the constituent republics. The resulting disorders could adversely affect the U.S.-Soviet detente and have unfavorable repercussions on developments in both Italy and Greece.

The European Community

After the completion of the E.C.'s customs union in 1967, the movement toward greater economic and political unification in Western Europe markedly slowed and, since the world petroleum crisis in the fall of 1973, it has halted. The questions are: Is it likely to be resumed and, if so, in what forms? If not, what other course of development is probable?

Meaningful answers to these questions can only be given in terms of

a valid and realistic definition of the concept of unification. A clear definition is necessary because, as the prospects for further unification have become dimmer, there has been an inconsistent tendency in both Western Europe and the United States indiscriminately to hail every instance of cooperative behavior by the E.C.'s members as a step toward union and at the same time to insist that the progress of the movement could not be judged in terms of a more or less specifically defined goal, such as an eventual political and economic union of some kind. There is some truth to each of these contentions but in neither case is it sufficient to make them valid standards for assessing the developmental significance of Community actions.

For example, it is reasonable to expect that, as a new and unprecedented European macro society, an emerging economic and political union would be most unlikely to copy closely any of the existing federal or confederal unions -- if only because they have had different historical backgrounds. Nevertheless, the fact that they can all be identified as belonging to the same class of macro societies means that they must all share certain distinctive characteristics, which together constitute the relevant standard for determining whether a developmental process is moving toward a union or not. Again, it is certainly valid to envision that the ongoing evolution of the Community might eventuate not in a form of federal or confederal union but in something totally new and as yet undefinable. But, this perspective for assessing the Community's development is not justified unless the movement toward the unknown destination can already be distinguished by certain identifiable characteristics from other movements toward definable goals, such as federal and confederal unions, and the further evolution of the process

projected in terms of its own distinctive emerging elements. In other words, it is impossible to discuss meaningfully -- let alone to make policy regarding -- the developmental prospects of the European Community except in comparison with a standard defined in terms either of a specified goal or of the distinguishing characteristics of the process of change itself.

From the beginning, the official goal of the Community's six original members has been an economic and political union of some kind. It has generally been envisaged as confederal in nature -- that is, member national governments would retain the essential sovereign powers over taxation, money and credit, and control of the armed forces but would delegate administration of common policies in important aspects of these and other fields to new central authorities. By this standard, the Community made substantial progress until completion of the customs union in 1967, including the arrangement for free trade in agricultural products known as the common agricultural policy. Since then, it has moved more and more slowly. In fact, such progress as the Community has achieved has been for the purpose of strengthening the customs union, taking the form of laborious and still far from completed negotiations to harmonize many national policies and regulations so as to equalize the conditions of competition within the common market.

The only effort to move significantly beyond the existing customs union was the proposal for monetary and economic union adopted early in 1971 and involving the gradual establishment of a common currency and delegation to the E.C.'s central organs of authority to harmonize the fiscal and monetary policies of the members to the extent needed to sustain monetary unification. However, the initial step toward this objective -- the narrowing of exchange-rate fluctuations among members'

currencies -- was first delayed by the international monetary crisis of August 1971 and then, after a short trial, was in effect reversed by the decisions of Britain, Italy and France to float their currencies.

Although the French have recently suggested reviving the scheme for monetary union, the external economic difficulties likely to confront them and other E.C. members in the coming years will in all probability preclude such a move.

A resumption of significant progress toward greater unification is unlikely during the remainder of the 1970s for two main reasons. Basically, as explained in Chapter I, the sociocultural changes characteristic of the new nationalism have strengthened the central institutions of nation-states at the same time as perceptions of the Soviet Union as the common external menace compelling Europe to unite or perish have weakened. Recently, the inhibiting effects of these and other developments on the unification movement have been compounded by the international economic strains generated by the quadrupling of petroleum prices. As sketched in the preceding sections, the resulting economic and political difficulties within three of the leading E.C. member countries are both narrowing the freedom of action of their governments to make concessions for the sake of greater European unification and raising serious doubts about the compatibility of their future regimes with those of other members.

In these circumstances, the more relevant question is whether the Community will be able to preserve the degree of unification it already

possesses rather than how much further it is likely to go. As presaged in 1974 by Italy's foreign-exchange deposit scheme to discourage imports, economic exigencies and internal political pressures in the next few years could constrain not only that country but perhaps also France, the United Kingdom, and some of the smaller members (e.g., Denmark and Ireland) to impose restrictions on trade and payments both with the outside world and with their E.C. partners, thereby in effect seceding at least temporarily from the customs union. Also, if the negotiations to reform the common agricultural policy result in de facto restriction of free trade in agricultural products among the members, then the customs union would be impaired in that important respect as well. Or, if the United Kingdom sells North Sea oil at a substantially lower price to its own producers than to its E.C. partners, they may be constrained to offset their resulting competitive disadvantage in some way.

To judge the developmental prospects of the European Community by the second standard, that is, as a distinctive evolutionary process toward a novel and as yet undefinable outcome, it is necessary to identify the distinguishing characteristics of the process itself. The distinctive institutional element is, of course, the customs union and its subsidiary common policies for equalizing the conditions of competition in the conjoined markets of the member nations. Another distinctive feature is psychocultural: the sense of a common European identity and a unique European destiny expressed more in terms of the Community's external relationships than of its further internal institutional development. Today's consciousness of Europe's meaning and destiny differs from those of the past -- for example, from the universalistic concept of Christendom that prevailed in the medieval period and from the 19th- and early

20th-century imperialistic concept of Europe as the leader in the planet's sociocultural progress and the paramount center of world political and economic power. While much of the feeling of sociocultural superiority still lingers, it no longer motivates and justifies an expansive and directive conception of Europe's role in the international system. Rather, it provides the sense of common identity helping to sustain the ongoing process by which the Community functions as an institutional means for protecting and advancing the common interests of its members vis-à-vis the rest of the world.

As such a pragmatic means, the Community complements and does not supersede -- as it sooner or later would have to do in terms of the unification perspective -- the unilateral pursuit of their national interests by its members through their own economic and political relations with nonmember nations. Unlike under the unification standard, therefore, the Community buttresses rather than erodes the institutions of the nation-state. It enables its member national governments to function more effectively -- or less ineffectively -- despite the impairment of their freedom of action in the integrated world economy inherited from the postwar period. Nor, in the pragmatic perspective, is it of crucial importance whether the Community becomes more or less unified internally -- for example, whether the scope of the customs union is reduced by the elimination of free trade in agricultural products or by the imposition of import barriers by a member with a large payments deficit, or whether steps are taken toward a monetary union. Rather, the Community's evolution would largely be determined by whether and in what ways the members agree that action through the Community best serves their own national interests.

Thus, in effect, collective action through the Community supplements the members' unilateral, bilateral and wider multilateral activities. For example, the members are endeavoring to work out a common E.C. energy policy and to carry on a collective discussion with OPEC while at the same time each seeks to make bilateral agreements with petroleum-producing countries and to participate individually in the OECD's International Energy Agency with the United States and Japan. To finance their payments deficits, Community members are simultaneously borrowing in the Eurocurrency and other private capital markets, arranging bilateral loans with OPEC governments, participating in the IMF's special oil facility, and establishing both an E.C. loan-guarantee scheme and the more extensive Kissinger-Simon Plan involving the other OECD countries.

In the pragmatic perspective, therefore, the Community is neither a concerted movement toward a European confederal union nor a traditional type of alliance formed for defined military, political or economic purposes. It is a novel kind of continuing, open-ended arrangement to collaborate in a variety of unspecified ways to protect or advance the national economic interests of its member states, based institutionally upon a customs union and psychoculturally upon a sense of common European identity and destiny that is expressed mainly in relationships with the outside world. The form into which the Community might eventually evolve cannot be foreseen. But, its process of development will continue to be determined by the more or less ad-hoc pragmatic characteristics that it has already manifested.

The unification standard for projecting the Community's future development accords with the members' officially designated objective and publicly proclaimed intention. But, the pragmatic standard is more consonant with present realities and future possibilities in the period of the new nationalism and of major new international economic strains. For this reason alone, the Community's prospective development is more likely to be along the lines of the latter than of the former.

If so, certain consequences would follow. The Community would not become sufficiently unified internally in the foreseeable future to act predominantly as a single unit in world affairs. Hence, it would not become a great world power capable of providing for its own defense and able to cope by itself with drastic adverse changes in the international political and economic system. Internally, it would be increasingly influenced by its strongest member, Germany; externally, it would continue to be dependent upon the United States for military protection, political support, and economic assistance. At the same time, the Community would enable its member states to preserve more freedom of action and to exert more leverage internationally than any of them could do by acting individually. And, over the long term, it is possible that, as such collaborative norms of behavior grow and the sense of common European identity strengthens, internal sociocultural changes and international political and economic conditions would once again become conducive to European unification, as they were in the postwar period.

Transatlantic Problems

During the late 1960s and early 1970s, important economic and political issues arose between the United States and Western Europe that reflected both the sociocultural developments within them and the changes in their relative positions in the international political and economic system sketched in Chapter I.^{2/} In the novel circumstances that have developed since the winter of 1973-74, some of these problems have disappeared, others have been modified or intensified, and new ones have already arisen or are likely to do so in the coming years. In turn, these changes have significantly altered the general mood or attitudinal characteristics of transatlantic relationships.

Prior to the winter of 1973-74, the prevailing tone of the relationship reflected, on the European side, the consciousness of Western Europe's increasing economic power and prosperity and the sense of its emerging international importance as its unification progressed; and, on the U.S. side, the converse awareness of the relative decline in the world economic position and political influence of the United States and its preoccupation with perplexing domestic problems and the frustrations of the Indochina War. Today, in contrast, these trends are reversed. The West Europeans have become painfully conscious of the precariousness of their prosperity, of the limitations of their world economic power, and of the likelihood of continuing international political ineffectiveness now that the European unification movement has stagnated and their dependence on the United States has once again become apparent. For its part, the United States has been impelled by its own national interests to a more active manifestation of the leadership role still implicit in

^{2/} For a fuller analysis of these political and economic issues and of the changes that generated them, see Geiger, The Fortunes of the West, cited, Chapter VI.

its superpower status even though its ability to exercise a determinative influence on the international system is much reduced from that of the postwar period.

These psychocultural changes on both sides are already being expressed in a substantial moderation of the contentiousness and acrimony that had increasingly characterized transatlantic relationships in the late 1960s and early 1970s. Even the French, who had previously taken the most extreme position in rejecting U.S. leadership and asserting their own -- and, at least verbally, a united Europe's -- political and economic independence, have been driven by their existing and prospective problems to a significantly more accommodating approach to U.S.-European relations, a change that was facilitated by the Gaullists' loss of the presidency and declining electoral support.^{3/} Thus, the nature of the difficulties with which the United States and Western Europe are confronted and the related changes in attitudes have already led to and will continue to sustain a notably more cooperative transatlantic relationship than existed before the winter of 1973-74.

At the same time, however, the deep ambivalences of interests and attitudes that formerly characterized the relationship have not been eradicated by these developments. Only the specific issues generating them and their forms of expression have been modified. Hence, the new

^{3/} Indeed, under President Giscard d'Estaing, France is enjoying the advantages of both approaches. Constrained by the anti-Americanism not only of the Gaullists but also apparently of a majority of the French people from rejoining the military part of NATO and participating in the oil-sharing arrangement with the United States, France nevertheless obtains the benefits of these and other cooperative transatlantic efforts while remaining free to cultivate the petroleum-producing countries in its own behalf and to further its national interests in other independent ways.

mood of transatlantic cooperation will coexist with old feelings of resentment and impatience. Indeed, the former will restimulate the latter. For the Europeans, the disappointment of their hopes for an increasingly influential role in the international system and their renewed dependence on the United States inevitably impel them to project onto it the blame for some of their frustrations and to feel embittered by the necessity of having to rely once again upon American goodwill and assistance. For their part, Americans are bound to resent the need to assume new responsibilities for Western Europe's economic well-being and political stability, as well as for its military security, at a time when they are preoccupied with their own problems and unable to satisfy sufficiently the other pressing claims on their limited resources.

In the following sections, the existing and prospective common and conflicting interests in transatlantic relationships are briefly characterized and their implications for U.S. policies assessed.

Probable Areas of Cooperation and Conflict

One major area of common and conflicting transatlantic concerns is the future of NATO. On both sides of the Atlantic, the willingness and ability to allocate resources for the maintenance -- let alone the improvement -- of NATO's nonnuclear defensive capabilities will probably continue to decline during the next three or four years. On the European side, this trend has already been presaged by the reduction in the forces committed to NATO by the Netherlands, even though its current economic situation and outlook are better than those of any other West European member except Germany. The Labour government in the United

Kingdom will probably be impelled to make further cuts in the British military effort that could significantly affect its NATO commitment. And, to the extent to which other European members encounter the economic and political difficulties that could arise in the coming years, they would be likely to follow the Dutch and British precedents in reducing their nonnuclear military capabilities as well. In turn, this trend would reinforce the efforts of those political and opinion leaders in the United States who argue that U.S. forces in Western Europe can be substantially reduced -- if not completely withdrawn -- in view of the detente with the Soviet Union.

One or more of several possible adverse consequences could follow from declining U.S. and European support for NATO's nonnuclear military capabilities. The first would be that, after encouraging this trend through its detente policy, the Soviet Union would be tempted increasingly to influence the actions of individual West European nations once the disproportion between its military power and that of NATO became great enough to add the intimidating weight of its military superiority to the economic and political pressures it could bring to bear on them. The second would be that, owing to its economic strength, West Germany's military role in the alliance would grow relative to those of the other European members, thereby arousing their fear of eventual German domination. The third consequence would be that, in the event of internal political conflicts or civil wars within one or more West European nations, NATO would not be strong enough to deter Soviet intervention in support of the popular-front or communist forces. In that case, the only alternatives open to the United States would be a nuclear confrontation

with the Soviet Union or indefinite involvement in a European equivalent of the Indochina War of the 1960s.

Moreover, even if NATO remained effective enough to prevent such developments, other serious difficulties could arise. For one thing, the possibility must be taken into account that some -- perhaps all -- West European governments would support the Arabs in a future Arab-Israeli war and would deny the use of their NATO facilities for the movement of U.S. arms and supplies to Israel. For another, if center-left or popular-front governments come to power in Western Europe, U.S. bases and NATO support facilities in the United Kingdom, the Low Countries, Italy and Greece, as well as in the Azores and Iceland, could become the objects of leftist demonstrations, and pressures for closing them and for withdrawing all U.S. nuclear weapons might grow too strong and continuous to be resisted. In these circumstances, even the safety of nuclear weapons stored in Western Europe would be jeopardized.

If the outlook for NATO is generally somber, the prospect for U.S.-European economic relationships is brighter. The formation of the International Energy Agency (IEA) by the OECD nations and the adoption of the Kissinger-Simon Plan to help finance the payments deficits of those countries are potentially the most significant measures of transatlantic economic cooperation since the Marshall Plan. Given the differences in interests and the shifts in capabilities between the United States and Western Europe that have emerged since the latter cooperative effort, the intended extent of the collaboration envisaged by these new agreements attests to the changes in transatlantic attitudes, noted earlier, that

have been induced by the nature of the problems confronting the countries concerned and their altered positions in the international system. The IEA involves not only the better-publicized contingency oil-sharing arrangement but also the less-well-known but potentially far-reaching coordination of efforts to conserve energy use and develop new sources of energy (including the requisite price policies), as well as the concerting of a common negotiating position vis-à-vis the OPEC countries. Assuming that agreement is reached on the participants' financial commitments under and the detailed workings of the Kissinger-Simon Plan -- and the U.S. Congress approves of the American share -- it will necessitate extensive consultations between lenders and borrowers on the latter's macroeconomic management policies, external financial obligations, exchange-rate policies, and other important aspects of their economic conditions and prospects.

It is no denigration of the scope and importance of these cooperative arrangements to recognize the possibility that the oil-sharing agreement -- the cornerstone of the IEA -- might be abrogated by some or all of the European members, as well as by Japan, in the event of another Arab-Israeli war, especially if it were precipitated by an Israeli surprise attack. True, the Arabs could not impose an effective embargo against the United States without also cutting their oil shipments to Western Europe and Japan, as they did during the 1973 war. However, not only France but also some of the other West European nations might conclude that the amounts of petroleum they would get by supporting the Arabs might still be significantly larger than their allocations under the oil-sharing agreement, especially if there were to be serious opposition in

the United States to exporting domestic supplies. And, the Arabs would certainly endeavor to encourage such a conclusion, as well as promising other benefits that would have the same effect. Thus, it is within the limits of the possible that economic difficulties and political pressures could compel some, at least, of the West European nations to abrogate the oil-sharing agreement and support the Arabs in the event of another Arab-Israeli war.

Other possibilities for transatlantic conflicts could arise from the fact that, in addition to their arrangements for mutual cooperation on energy problems and for joint negotiations vis-à-vis OPEC, the United States and those West European nations able to do so will continue to negotiate bilateral agreements with individual oil-producing countries involving armament sales and military training, as well as the trade, investment, technology transfer, and other benefits desired by the latter. Such bilateral deals are inherently competitive and hence could lead to transatlantic disputes. More serious, the pressing needs of the West European nations and their weaker bargaining power could constrain them to make agreements with oil-producing countries covering not only trade and investment but also political alignments and actions by the Europeans that -- along with the support they might give to the Arabs in a future Arab-Israeli war -- would help to undermine U.S. policies relating to the Northwest Indian-Ocean region discussed in Chapter III, as well as perhaps to other parts of the world.

Beyond the possible conflicts directly related to the world energy situation, other economic developments could cause disputes between the United States and Western Europe. Potentially the most serious are those

that could be generated by uncoordinated efforts of OECD nations to cope with the severest world economic recession since the great depression of the 1930s. In the next year or two, high unemployment could impel some OECD countries -- including the United States in view of the presidential election in 1976 -- to impose import restrictions of one kind or another, to subsidize manufactured exports by various means, and to limit capital outflows. If world agricultural shortages recur, they could lead to restrictions on U.S. agricultural exports to conserve domestic supplies and keep prices down. And, the continued high rates of inflation in the OECD nations and the present synchronization of their business cycles mean that, the more drastic their antirecessionary measures, the greater the stimulus to further inflation after the economic recovery has gathered momentum. At bottom, the danger is that unilateral actions will result not only in retaliatory measures but, more important, in adverse positive feedback effects on the economies of the OECD nations on the down side and on the up side. Major transatlantic conflicts are implicit in this possibility, which would also have very serious political repercussions within Western Europe.

Other possible transatlantic conflicts could arise over changes in the nature of and rules governing the international economic system. The new round of GATT negotiations will inevitably involve disagreements between the United States and West European nations over nontariff barriers, export subsidies, trade in agricultural products, and the other matters under negotiation. But, it is likely that compromises on these issues will eventually be reached. Potentially more serious is the possibility that major differences will emerge between the United States and the West European nations as to whether and how to meet the demands of the

Group of 77 developing countries for a "new international economic order" -- essentially for a substantial redistribution of world income in their favor. The recent agreement by the European Community to stabilize the agricultural export earnings of the former colonies of its members in Africa, the Caribbean and the Pacific (the ACP countries) may foreshadow conflicting approaches on opposite sides of the Atlantic to commodity agreements with raw-material producing countries and the formation of bloc or bilateral preferential trade and investment relations. E.C. and U.S. policies could also diverge with respect to the response to be made to developing country pressures for changes in quotas and voting power in the IMF, controls on multinational companies and private foreign investment generally, and other issues.

Another set of possible transatlantic disputes could arise from changes that the European Community might make in the next few years both in its internal policies and in its relations with its free-trade affiliates in Europe and its associated countries overseas. The Community is planning to renegotiate the membership agreements with Greece and Turkey and to negotiate new or revised association agreements with many Mediterranean countries, including Spain and Portugal. These will undoubtedly involve preferential arrangements that would discriminate against U.S. exports both to Community members and to the associated countries. The periodic revision of the common agricultural policy could lead to further subsidies of Community exports and new restrictions on E.C. imports from the United States, especially if world food- and feed-grain supplies become more plentiful and the West Europeans are successful in their present efforts to develop soybean production on a substantial scale. Another possible source of conflict could be the bilateral agreement proposed by Canada -- to which, however, the Community has so far been cool precisely because of its adverse repercussions on E.C.-U.S. relations.

Other likely developments within the Community that could cause serious disagreements with the United States relate to the nature and extent of private enterprise in Western Europe and the activities there of U.S. multinational corporations, banks and other private investors. One potential source of controversy included in this heterogeneous category is the industrial policy that the European Community has been attempting to formulate, especially the possible discriminatory features of the effort to consolidate and stimulate Western Europe's high-technology industries (electronics, computers, aerospace, nuclear power, chemicals, etc.) so that they could more effectively compete within the common market and abroad against U.S. companies in these fields. A second is the trend both in individual countries and in the Community's proposed European company law toward worker representation on the governing boards of business firms, which would affect U.S.-owned companies and subsidiaries. A third development relates to restrictions on the freedom of private enterprises to hire and fire employees and to their growing financial and other obligations to redundant workers. These and other related trends could be objected to or resisted by U.S. companies as discriminatory, financially burdensome, or contrary to their accepted procedures -- reactions that would sooner or later involve the U.S. government in such disputes.

Finally, the most serious of all the possible sources of transatlantic conflict would be the nationalization, income-redistribution and other policies that Socialist-led and popular-front coalition governments on the continent and a left-dominated Labour Party regime in the United Kingdom would be constrained to follow. These developments would probably

generate serious disputes over compensation for partially or wholly nationalized U.S. companies, over greatly increased -- especially if discriminatory -- taxes on them, over the export obligations of U.S.-owned manufacturing firms, over wage and price controls, over official supervision of the investment plans of existing U.S.-owned companies and restrictions on new U.S. private investment, over the operations of branches of U.S. banks, over foreign-exchange controls and transfers of U.S. private funds, and over the employment and personnel policies and the social-welfare responsibilities that U.S. firms had to implement. Some of these problems could also arise under highly nationalistic or radically oriented military dictatorships. In view of the magnitude of U.S. private investment in Western Europe and its importance for the U.S. balance of payments, the U.S. government could not avoid becoming involved in such conflicts even if it wanted to resist the pressure from the companies concerned for protective action.

The coming to power in Western Europe of new military dictatorships and Socialist-led or Communist-dominated coalitions would generate a variety of political issues between these regimes and the United States in addition to those arising from possible economic disputes. They would include intensified versions of the problems relating to the future of NATO discussed at the beginning of this section; the repercussions of the repressive measures enforced by such regimes; their possible new alignments vis-à-vis the Soviet Union, the oil-producing nations and other groups of countries with significant international political or economic power; their participation in the

United Nations, the IMF, the OECD, and other important international organizations, and other potential sources of concern to the United States.

In sum, even assuming that moderate democratic regimes like those now in power continue to exist in Western Europe, it is clear from the foregoing survey that transatlantic relations during the remainder of the 1970s will be characterized by an often contradictory mixture of cooperation and conflict. Just as the West European nations now use their membership in the European Community as a pragmatic multilateral means for supplementing their own unilateral efforts to protect or advance their national interests, so do they regard their relationship with the United States as another means useful for the same purposes. Under this expedient approach, they will cooperate with the United States in the specific ways and at the particular times that they believe will serve their own interests. Simultaneously, they will pursue other or even the same interests by other unilateral and multilateral means even though such efforts may -- in some cases inevitably will -- involve them in conflicts with the United States. Nor can these inconsistencies be resolved in the light of or subordinated to a unifying goal, as they were in the postwar period through the hegemonic leadership of the United States and the shared integrating concept of an "Atlantic Community" with a distinctive identity and special role in the world. The United States no longer possesses hegemonic power of that kind, and the sense of belonging to an emerging Atlantic Community largely disappeared in Western Europe during the 1960s. Today and for the

foreseeable future, the United States must deal with pragmatic -- sometimes opportunistic -- West European states that seek to protect and advance their interests under the domestic and international compulsions of the period of the new nationalism and by whatever unilateral and multilateral means seem most effective at any particular time.

Implications for the United States

It is impossible to prescribe in any detail the specific policies that the United States would have to follow in order to cope effectively with the more and the less probable developments in Western Europe projected in this chapter for the remainder of the 1970s. Not only are the goals involved of a general kind but also the choice of effective means for achieving them always depends upon the unpredictable situation-specific circumstances in which they have to be applied. All that can usefully be done in a projective study, therefore, is to describe in general terms the positive and negative goals within the limits of the possible that are relevant to U.S. interests and to propose some general guidelines regarding the extent to which and the ways in which U.S. actions are likely to be conducive to them.

Since the beginning of the 20th century, a basic tenet of U.S. foreign policy has been that both the security and the economic well-being of the United States would be drastically impaired if the immense human energies and productive resources of Western Europe were to be controlled by an expansionist superpower or potential superpower and one, moreover, whose economy was not in substantial degree a part of and subject to the constraints of the international market system. Basically, this

long-felt concern has expressed the interactions among the institutional nature of American society, the distinctive perceptions and conceptions inculcated by its culture, and the changing condition of the international system. The predominant conviction has always been that this danger could be prevented by preservation of independent democratic regimes in West European countries, which depended essentially upon their ability to satisfy the expectations of their people for improved conditions of life and for the continuity of their unique cultural identities developed during long, memorable historical backgrounds. In turn, these requirements are conditioned upon security against outside aggression, domestic peace and order, a rate of economic growth significantly in excess of the rate of population growth, and a sense of psychocultural integrity and independence. Since World War II, U.S. policy has been designed to help assure these necessary conditions for the continued existence of independent democratic regimes in Western Europe either on a separate national basis or in a European union of some kind.

The adverse interacting economic and political developments, projected in earlier sections of this chapter, that could threaten the persistence of democratic regimes in certain European nations have a sufficiently high probability to warrant efforts by the United States to help prevent them. Conversely, if this worst-case course of events does not occur, there are likely to be, even in the best of possible circumstances, serious transatlantic issues -- outlined in the preceding section -- with which the United States will have to cope in the years ahead. It is fortunate that the kinds of policy measures which the United States could undertake to mitigate or resolve these issues are also among those needed to help

ward off the possible worst-case developments. Thus, by following appropriate policies, the United States can both deal effectively with the more likely kinds of problems and reduce further the lesser -- but still significant -- probability that the worst-case outcome would come about. The general guidelines in these respects for U.S. policy are indicated in the remainder of this chapter.

1. To cope with the large balance-of-payments deficits that some European nations are likely to incur in the next few years, the United States has already taken the lead in initiating the Kissinger-Simon Plan and has agreed to continue and increase the IMF's special oil facility. Because the magnitude and duration of the OPEC surplus now appear to be substantially less than originally feared, these extraordinary financing facilities -- along with the new E.C. loan-guarantee agreement, the existing swap arrangements, the regular IMF credit availabilities, and the resources of private capital markets -- are likely to be sufficient to take care of the borrowing needs of the West European nations. (The financing problems of the developing countries are outside the scope of this study.) The United States should endeavor to assure that the criteria for access to these facilities do not require the borrowing nations to impose severely restrictive measures that would lead to or perpetuate high unemployment and reduced real incomes. For, the purpose of this extraordinary financing is not to compel the borrowing countries to financial rectitude for its own sake. It is precisely to enable them to mitigate sufficiently the internal rigors of the adjustment process so as to prevent the adverse courses of interacting economic and political developments that might otherwise occur in Italy, France, the United Kingdom, and the southern

European nations. Moreover, it is probable that, in Greece, Portugal, Spain, and perhaps Italy, their domestic circumstances would be such as to make credits from the IMF or under the Kissinger-Simon Plan inappropriate or inadequate, thereby necessitating direct economic aid from the United States and West Germany. This possibility should be included in U.S. contingency planning.

2. It is also important to emphasize the necessity for better transatlantic cooperation on macroeconomic management policies than has hitherto prevailed. For as long as cyclical behavior remains synchronized in the OECD countries, the danger of adverse positive feedback effects from uncoordinated policies in both the down and the up phases of the cycle will persist. Hence, the greater the economic difficulties confronting the United States and Western Europe in the next two or three years, the greater the need to coordinate their macroeconomic management policies more effectively. The problem is one of willingness, especially in the United States where domestic considerations dominate policy making. Adequate institutional means already exist for improving transatlantic macroeconomic cooperation in the facilities provided by the OECD, in the regular central bankers' meetings in Basle, and through the informal meetings of finance ministers from the leading OECD countries.

3. Specific policy prescriptions for dealing with particular issues in trade, investment and other aspects of transatlantic economic relationships require detailed technical analysis that is outside the scope of this study. A general guideline can be suggested, however. Granted the domestic and international pressures of the current period of the new

nationalism explained in Chapter I, the United States will be impelled to follow a more directly and narrowly self-interested approach than in the postwar period. But, even within these limitations, mutually acceptable resolutions of these issues can be reached if -- as still by far the most powerful country within the OECD and the one with the least restricted freedom of action -- the United States is willing to come forward with constructive ideas that take into account the domestic and international constraints of the West European nations. This means refraining from manipulative efforts aimed to compel the Europeans to support U.S. interests that they do not share, and resisting the inevitable pressures from opinion leaders at home to relapse into truculent confrontations, like those of the late 1960s and early 1970s.

4. A similar forward-looking approach is needed to deal effectively with the somber outlook for NATO projected in the preceding section. Both the requirements for European defense and the U.S. role in it have to be reassessed in the light of the probable political and economic developments in Western Europe in the years ahead. This reexamination will be fruitful to the extent that U.S. policy makers view the problems involved in terms of the new possibilities and limitations of the future and are not bound by the conceptions of needs and capabilities that determined NATO's past. Only such an approach is likely to produce the necessary new ideas about men, armaments, bases, deployments, logistics, and nuclear and nonnuclear strategies. It is also important to help dispel the unrealistic expectations of many political and opinion leaders in the United States that the West European nations would be willing or able to increase their NATO contributions in the coming years.

5. Granted that military dictatorships, communist-dominated popular-front governments, and even civil wars are no longer outside the limits of the possible for Western Europe in the foreseeable future, it is of primary importance for the United States to try to ward off such adverse political developments by the kinds of economic measures noted above. Nevertheless, the possibility must also be taken into account that the underlying economic and political trends may be so unfavorable and/or the remedial measures may be so inadequate or so late as to lead to military dictatorships or communist-dominated coalitions in one or more West European nations. Again, it is not possible to prepare now detailed contingency plans for U.S. policies and actions to deal with these possible adverse political developments because the distinctive complexities and ambivalences of each such situation cannot usually be discerned with sufficient clarity until the course of events leading directly to it is under way. As requested, however, a general guideline can be indicated. It is that, all other things being equal, if a democratic regime in a West European nation can no longer survive, its replacement by a right-wing or military dictatorship would be less inimical to U.S. security and economic well-being than by a communist dictatorship. This is because the former would be less likely to be affiliated with -- or to become itself -- an expansive superpower and would be more likely to remain an integral part of the international market economy than would the latter. The major exception would be an authoritarian right-wing or military regime dominated by a psychopathic personality, like Hitler, who would be prone to risk nuclear wars of conquest and commit genocide or other comparable atrocities. This general criterion does not necessarily mean that the United States

should help to bring about right-wing or military dictatorships in European countries to forestall or overthrow popular-front coalitions, or that the coming to power of a communist regime would be an unsupportable disaster. The former might be counterproductive and the latter tolerable. Decisions as to whether and how to intervene can be meaningfully made only in specific circumstances. But, it is relevant to urge that, when action is decided upon for whatever reasons, the various lessons to be learned from U.S. relationships with Cuba before and since Castro's coming to power, Greece under the military dictatorship, and Chile during and after the Allende regime need to be carefully analyzed and objectively assessed.

6. Special attention should be given to West Germany's prospective role in Western Europe and to U.S. relations with that country. Under any of the courses of development projected in this chapter, German economic strength and political importance are bound to increase both absolutely and relative to those of the other West European nations. If only to minimize the strain on its own resources, the United States will be justified in pressing the Germans to share in the major responsibility of providing economic assistance to other West European nations and to offset, insofar as necessary, the reductions in the latter's military commitments to NATO. The United States and Germany have strong common interests in preventing the adverse political developments that could result from severe economic difficulties within the vulnerable West European nations and that could also make possible rapidly growing Soviet pressure on and influence in the region. Thus, a kind of tacit U.S.-German partnership will probably emerge for assuring the military protection, economic

effectiveness and political stability of Western Europe. The likelihood of this development makes it all the more important that U.S. policy makers should be mindful of the risks involved. As explained above in the section on West Germany, the more powerful and important the role that Germany plays in Western Europe, the greater the probability that hegemonic ambitions of one kind or another would revive to fill the existing lack of a sense of self-justifying national identity and purpose. The likelihood of such a development will be increased as more and more of Germany's present political and opinion leaders die or retire and are replaced by a younger generation that has not had its self-conceptions muted by the shame of Nazi atrocities and the chastening effect of total defeat. Therefore, in working out their new relationship with Germany, U.S. policy makers have the difficult and subtle task of encouraging the Germans to assume the responsibilities appropriate to their economic power without at the same time stimulating the emergence of the hegemonic aspirations latent in such a role.

7. As implied in #3 above, it is important that the U.S. government conduct its relations with European governments in a manner that minimizes the resentments inevitably generated not only in France but in other West European nations by the frustration of their expectations of achieving an independent and influential role in world affairs and by their renewed dependence on the United States. No effort should be made to revive any of the Atlanticist concepts of the postwar period, and the appearance should be avoided that the United States is once again pressuring West European governments to take actions "for their own good." Similarly, on this side of the Atlantic, it is equally important to refrain from

aggravating and to counteract the impatience and resentment that many U.S. political and opinion leaders will be bound to express at the inability of the U.S. government fully to satisfy U.S. national interests vis-à-vis the West European countries and at the need once again to help them deal with their problems. Thus, as many appropriate opportunities as possible should be sought to explain to the Congress, the media and the American people the objectives of U.S. policy toward Western Europe and the limitations imposed on U.S. freedom of action by the complexities and ambivalences of the period of the new nationalism.

Chapter III

THE PROSPECTIVE INSTABILITIES OF THE NORTHWEST

INDIAN-OCEAN REGION

This chapter deals with the problems of concern to the United States that are likely to be generated over the next five to ten years by the internal sociocultural developments and the mutual interactions of the nations in the region stretching from Egypt and the Horn of Africa on the west to the Indian subcontinent on the east. It is designated as the Northwest Indian-Ocean region because all of the countries considered here border on the Indian Ocean or on its two major extensions, the Persian Gulf and the Red Sea.^{1/}

These nations have been selected for study and combined into an unconventional regional grouping for that purpose for two related reasons. First, while the Arab states of West Asia and Northeast Africa have long constituted a sociocultural area in the fullest historical and sociological senses of the term, their political and economic interactions with Iran and with the nations of the Indian subcontinent (which form a different sociocultural area) are becoming increasingly extensive and will exert a more and more important determinative influence on the future courses of development of all of these countries.

^{1/} The geopolitical region covered in this chapter overlaps in part with those usually included in the Near East and the Middle East but it also extends further eastward. In any event, the latter two regional designations are not used here because their coverage is vague and, like the term Far East, they have been rejected as Eurocentric by the nations involved.

Second, the internal processes of sociocultural change within the leading nations and their intraregional relationships will probably be of such nature as to make this region a major -- perhaps the main -- source of instability in the international system over the next five to ten years, and hence of great concern to the United States.

The increasing international significance of this region today and for the foreseeable future contrasts with its comparative lack of importance during the postwar period, except for moments like the Suez and Lebanese crises of the 1950s. Then, the Indian Ocean was indeed an "ocean of peace" in the often-used phrase. During those years, neither the United States nor the Soviet Union stationed naval forces in those waters, and the British military presence in the Gulf and at Aden near the entrance to the Red Sea was the last remnant of the historical hegemony that the United Kingdom had renounced in the great decolonization movement after World War II. Moreover, despite the global nature of the cold war, the Arab part of the region was generally free of superpower confrontations, reflecting the then relatively minor importance of its main natural resource, oil, to the United States and the Soviet Union, and the superpowers' preoccupation with their conflicting interests and their commitments in other parts of the world. Thus, for much of the postwar period, the Arab nations were largely left to themselves and, except for their conflict with Israel, were mainly concerned with their own internal processes of sociocultural development and with their rivalries with one another.

The growing international importance of the region as a whole since the onset of the current period of the new nationalism in the mid-1960s reflects two interrelated sets of changes, one exogenous and the other endogenous. The first includes the gradual moderation of the cold war into competitive coexistence, described in Chapter I. These changes in the relationships between the United States and the Soviet Union have made it possible for each superpower to become increasingly active in the region, as its perceived interests and opportunities therein have grown, without the logic of their mutual distrust impelling it to interpret every move by the other as a threat to its position requiring an appropriate reaction. Soviet motivation for greater involvement in the region is analyzed in a later section of this chapter. In the case of the United States, its more active concern results not only from its commitment to Israel but also from the ending of its self-sufficiency in petroleum and its rising oil imports from the region, as well as from the very much greater dependence of its NATO allies and Japan on regional oil supplies.

Concurrently, within the region, the petroleum-producing nations accepted Venezuela's invitation to form the Organization of Petroleum Exporting Countries (OPEC) in order to take advantage of growing international demand for oil to raise their export prices. Then, in a highly significant development, the Arab members perceived the opportunity to use their monopoly power as a political weapon to pressure the United States, Western Europe and Japan to support their efforts against Israel. At the same time, the increasing wealth and international

importance of the region have stimulated the hitherto slow processes of sociocultural change within the leading Arab nations and Iran and thereby heightened the potential for growing instability both within these countries and in their relations with one another. Finally, greater intraregional instability is likely to result from the fact that India is being impelled into increasingly close economic, political and perhaps even military interactions with Iran and the Persian Gulf states. This trend reflects India's growing hegemony over the other nations of the subcontinent, its achievement of a nuclear capability, its concern over the U.S. and Soviet naval forces now stationed in the Indian Ocean, its own import needs, and the compulsions toward westward expansion that could be generated by its mounting internal economic and political difficulties.

This chapter deals with the ways in which this transformation of the region from a comparative backwater of world politics and economics into an area of increasing importance in the international system is likely to develop in the future and with the problems that the ambitions and instabilities of its constituent nations will probably create for the United States in the next five to ten years. First, the processes of internal sociocultural change in the leading countries of the region are analyzed, and their likely future developments are projected. Then, the nature and motivation of Soviet involvement in the region are assessed. Next, the present and prospective interactions of the leading nations with one another and with the competing superpowers are sketched. Finally, the implications of these more and less probable developments for U.S. policy are evaluated.

Before turning to these subjects, however, a word needs to be said about why the Arab-Israeli conflict is not treated at length here. As a long-preexisting problem, it is strictly speaking outside the scope of this study. But, this omission does not vitiate the analysis. Significant as a new and more destructive Arab-Israeli war or, conversely, a peace settlement would be in other respects, they would be likely to affect the timing rather than the nature and outcome of the internal and intraregional instabilities that will probably manifest themselves in the years ahead. The reasons for this conclusion are explained in a later section.

Internal Sociocultural Change and the Problem of Stability

For reasons that will become clear in the course of the chapter, the future of the Northwest Indian Ocean region will very largely be determined by its constituent states. This justifies a separate analysis of those nations likely to play the more decisive roles in intraregional affairs. Individual treatment is particularly necessary because of the variety of societies and cultures in the region, which includes modern descendants of three great historical civilizations -- the Arab, the Indian and Iranian. Even within the two former, the differences among their members in institutional systems and norms of behavior profoundly influence the manner in which each of them is currently passing through the transition from a traditional to a modern society.^{2/}

^{2/} For a detailed analysis of the process of sociocultural change from traditional through transitional to modern societies, see Geiger, cited, The Conflicted Relationship, Chapters Three and Four.

The nations analyzed in this section are Iran, Egypt, Saudi Arabia, Iraq, and India. These countries are not necessarily the only ones that will influence intraregional affairs; but, for reasons peculiar to each, they should have the most decisive effects. Although others are important, too (e.g., Ethiopia, Pakistan), time has not been available for detailed consideration of them.

The first two states -- Iran and Egypt -- are the least unstable in the region, and the next two -- Saudi Arabia and Iraq -- are the most unstable, with India constituting an intermediate case. In the sense used here, the term instability refers to the more or less precarious internal balance in transitional societies among the old institutions and the new, the traditional values and norms of behavior and the modern, the progressive social groups and political factions and those seeking to preserve the past. Such a balance has to be maintained if a transitional society is to adapt to the modern world without rending apart the fragile social cohesion that holds together its incompatible institutions, inconsistent values and conflicting particularistic groups. This balance is most critical in the political system of transitional societies because, in such newly independent nation-states, it is the primary means for social integration, the determination of national development strategy, and the forging of a new sense of cultural and national identity. Hence, a minimum degree of internal political stability is essential to maintaining momentum in the modernization process.

Iran

The modernization process in contemporary Iran owes much to the ideas, energy and skill of Reza Shah, the founder of the present ruling dynasty, and his son Mohammed, the reigning Shah. Both monarchs have been able simultaneously to maintain their own autocratic power through the traditional support given to their office while undermining the power of their traditional political counterweights: the nobility, the clergy, the bazaar merchants, and the artisan guilds. One by one, the traditionally powerful groups found themselves either replaced, as in the case of the smaller traders and artisans, or forced to depend upon the Shah for continuation of their privileges, as in the case of the landowners and wealthier merchants.

Reza Shah began the process of modernization during the 1920s and '30s first by seeking to deprive the nobility, clergy, bazaar merchants, and guilds of their power and, second, by trying to make the new professional and business groups and the peasantry and urban lower classes associate reform and socioeconomic progress with the royal family. To these ends, the Shah abolished the political privileges of the nobility, secularized the clergy's property, consolidated much of the existing industry under the government's control, created a Western-style bureaucracy, imposed Western-type dress, and introduced civil marriage and divorce. Most important of all for the stability of his rule, he modernized the army, granting it a privileged social position to assure its dependence and loyalty.

World War II and the occupation of Iran by the Allies forced Reza Shah's abdication, which was followed by a period of de facto rule by the National Front under Mossadeq, who nationalized petroleum production. After the army thwarted an abortive coup in 1953 by Mossadeq, the present

Shah Mohammed was able to secure full power. During the ensuing years of the 1950s, he consolidated his autocratic rule by suppressing extreme nationalists, leftists and fanatical religious elements. He also made an agreement with the expropriated oil companies that permitted the resumption of petroleum production and sales and thereby provided the revenues for embarking upon economic development.

By the early 1960's, the Shah had both the political security and the economic means to resume his father's modernization effort with the so-called white revolution. Its central feature was the redistribution of land to the peasantry. The conservative landowners and clergy allied themselves with the remains of the communist-dominated Tudeh Party and the National Front and incited rioting in the major urban areas in opposition to the Shah's program. But, the army remained loyal, order was reimposed, and elections were held in September 1963 that gave the Shah's supporters an overwhelming majority in the thereafter subservient Iranian parliament. At the same time, economic growth continued at an accelerating pace under a succession of development plans. These changes reinforced the Shah's efforts to replace the traditional elites with new modern groups of government bureaucrats, technocrats, businessmen, and professionals, all of whom were in one manner or another dependent upon the regime. Thus, by the end of the 1960s, the social structure had been altered and the economy had been launched into growth and modernization without undermining the autocratic power of the traditional monarchy, an accomplishment with little precedent in Asia or Africa.

In the light of these basic soclocultural changes and of the much accelerated rate of economic development that will result from the great increase in oil revenues since 1974, the question is whether the traditional autocratic rule of the Shah will continue or whether it will be replaced by another type of more or less authoritarian regime. The latter could come about through the willingness of the Shah gradually to transfer political power to the new modern elites or through the overthrow or replacement of the monarchy by a military coup or a leftist-led revolutionary outbreak by the urban lower classes. The relative probabilities of these possible outcomes may be briefly assessed.

The great bulk of Iran's people still live in the countryside and are engaged partly or wholly in subsistence agricultural or pastoral activities. The Iranian peasantry has traditionally been passive and, now that many families have received land through the white revolution, peasant revolts on any significant scale seem unlikely in the next five years or so. The exception would be unrest among ethnic minorities along the eastern border (e.g., Baluchistanis). But, such ethnic outbreaks would not seriously threaten the Shah's regime.

The major danger of political instability is in the urban areas where, as in other developing countries, the population has increased much faster than employment opportunities. In addition to unemployment and underemployment, inflationary pressures in recent years have compounded its difficulties. With little or no education or capacity for independent organization, the lower-income urban workers and the unemployed are inclined to follow unquestioningly those who represent immediately perceived

authority (e.g., bazaar merchants, the clergy, etc.) or who can articulate their grievances and provide organizational leadership (e.g., educated, disaffected members of the higher-income groups). They were readily induced by the former to riot against the white revolution in the early 1960s, and it is possible that, if inflation rises or a drastic decline in oil revenues leads to increased unemployment, they could be organized by the latter into strikes and demonstrations aimed at overthrowing the Shah's regime.

The educated, disaffected groups are chiefly the students and the lower-echelon bureaucrats. Since its inception under Reza Shah, the government bureaucracy has been the most available means of social mobility open to the educated members of the middle- and lower-income classes. As they increased in number, so did the applications for the civil service. Eventually, the limit of available jobs was reached, yet the student population continued to grow (in the universities alone, enrollment has doubled since 1968). The highest rate of unemployment is among recent graduates, while the seniority system in the civil service has led to a top-heavy bureaucracy with little upward mobility, freezing younger, better-trained government employees in lower-echelon, poorly paid positions. These dismal prospects have been a serious blow to the rising expectations of these groups, constituting a reason for the hostility to the existing regime of many Iranian students in North America and Western Europe. Owing to their education, the lower-echelon bureaucrats and the unemployed graduates have both the motivation and the ability to articulate their own and others' grievances, and their institutional experiences foster their capacity for political organization. Hence, from their ranks would come the disaffected politically conscious persons able to organize and lead the urban poor

and unemployed in revolutionary outbreaks against the regime and to engage themselves in urban guerrilla activities.

Another group likely sooner or later to oppose the autocratic rule of the Shah are the new modern elites -- the politicians and businessmen, professionals and technicians, upper-echelon bureaucrats and top officials of government-owned industrial enterprises. Their numbers and economic importance are bound to increase rapidly in the foreseeable future as the expanded oil revenues accelerate economic development. Hitherto, they have generally been loyal to the Shah, whose policies have largely been responsible for their growing prosperity. It is possible that the Shah will eventually be willing to concede a growing share of real political power to these groups. Nevertheless, the longer he wields autocratic control, the more difficult psychologically it becomes for him to yield to them the increasing decision-making responsibilities they will more and more expect. However, in contrast to the old traditional elites -- the landowners, clergy, bazaar merchants, etc. -- who instigated and financed the riots against the Shah's regime in the early 1960s, these modern upper-income groups are likely to feel that they have too much at stake to risk the uncertain outcome of provoking popular unrest. Hence, their dissatisfaction will largely be expressed in overt and covert criticism.

To nullify or repress these diverse kinds of actual and potential opposition to his authoritarian regime, the Shah has powerful resources of his own. One is the traditional respect for and loyalty to the throne, which the Shah endeavors to sustain by recollections of the long and glorious Persian past and promises of Iran's future as a great world power. Another

is the heightened prestige he now enjoys by virtue of the success of his petroleum policy. More important, some of the resulting immense financial resources at his disposal are now being allocated to develop labor-intensive industries and other employment opportunities for the urban groups, to modernize the civil service, and to improve income distribution.

Finally, the Shah will in all probability be able to count upon the effective support of the armed forces in suppressing urban unrest. Most of the troops are recruited from the countryside, and the officers are largely trained in Iran, rather than abroad, in contrast to the practice in Saudi Arabia and other Arab states. While debarring the military, too, from participation in the political process, the regime assures their loyalty by giving them exceptional economic privileges and high social status. The Shah keeps alive their consciousness of Iran's glorious history and fosters their traditional sense of fealty to his office. Thus, the armed forces have a compelling interest in the perpetuation of the existing regime and help to give it a degree of stability unmatched by any other traditional monarchy.

For these reasons, the probability is substantially greater that the Shah's regime will be able to maintain itself in power for the remainder of the 1970s than that it will not. Indeed, it is unlikely that a serious challenge will arise until after the Shah's death -- or assassination. If the successor were still a minor, the ensuing regency might be too divided or weak to govern effectively; and, if the new Shah were old enough to rule, he would nevertheless lack his father's prestige and the momentum of a long

and successful reign. In such circumstances, however, the incapacity of the regime or a revolutionary threat to its continuation would probably provoke the military to seize power, with or without the support and participation of the modern elite groups. Over the long term, accelerated economic development will inevitably be a major destabilizing force but the particular ways in which its effects could be manifested cannot now be foreseen. For the remainder of the 1970s at least, the most likely outlook for Iran is for continuing political stability under either the existing autocratic monarchy or an authoritarian military regime.

Egypt

Egypt is the most populous, economically developed and militarily powerful state in the Arab part of the Northwest Indian-Ocean region -- for that matter, in the entire Arab world. And, as in Iran, Egypt's authoritarian political regime is relatively stable even though its leading personalities may change.

Culturally, Egypt has a remarkable degree of homogeneity and continuity. Presently, only 1.5 percent of the population is not Arab-Egyptian, 92 percent are Sunni Muslims, and Arabic is the native tongue of 98 percent of the people. Since the unification of the Upper and Lower Kingdoms of the Nile in the third millennium B.C., Egypt has encompassed the same habitable region -- the Nile valley and delta. Although there have been numerous invasions and protracted periods of domination by alien conquerors, the isolated position and homogeneous character, as well as the extreme age, of Egyptian society have prevented major disruptions of sociocultural continuity. The exception was the introduction of Islam, but even that foreign influence was soon absorbed and Egyptianized without a major cultural break. Thus, after Napoleon's invasion of Egypt at the end of the 18th century, it was able to sustain the much more destabilizing

penetration by Western institutions, ideas and behavioral norms with remarkably little loss of the sense of cultural and national identity, in contrast to most other Asian and African countries. In this respect, Egypt has resembled Japan and China.

Since the overthrow of the monarchy in 1952, Egypt has been ruled by an authoritarian military regime. Dominated for over a decade and a half by the charismatic personality of Nasser, the regime has been headed since his death by the more subtle and flexible Sadat, another member of the original revolutionary group of largely middle-class officers. Although the personalities at the top may change, the authoritarian military regime has been in firm control of the country and seems likely to continue in power for the foreseeable future despite the increasing number and economic importance of the bureaucrats and technocrats and of the other modernizing groups in the society.

The Egyptian peasantry has from time immemorial been one of the most passive -- perhaps the most docile -- in the world, and it continues to manifest this characteristic. With the bulk of the men in the armed forces of rural origin, the peasantry constitutes a secure basis for the regime's power vis-à-vis the much more volatile urban lower-income groups and the other classes in the population. Even though agricultural production and incomes have lagged, the loyalty of the peasantry has been fostered by the partial land reforms imposed by the military regime and the consequent declining influence in the countryside of the traditional landowners.

Even before the military regime seized power, Egypt was more industrialized than the other Arab countries and it had a larger, better-

educated and more modernized middle class engaged in industrial and commercial activities. Although Cairo has long been the center of Islamic learning, Egyptian professionals and intellectuals have tended to be less orthodox and more progressive than elsewhere in the Arab world, except perhaps in Lebanon. On the one hand, the ruling military elites are themselves products of this urbanized progressive middle-class background; on the other, the main potential opposition to their regime comes from the businessmen, technocrats, professionals, intellectuals, and students comprising this group. True, there are orthodox Moslem sects and organizations opposed to the regime but, so long as the latter maintains the support of the peasantry, the former does not constitute much of a threat except in a conspiratorial way.

The guiding principles of the military regime have been Arab socialism and Arab nationalism. Arab socialism has meant a mixed economy, with a large public sector embracing basic industries and the more advanced-technology industries, as well as transportation and communications. The scope for private enterprise was being steadily narrowed by Nasser during his last years but this policy has been relaxed under Sadat. Arab nationalism was also conceived by Nasser in a highly activist and expansionist form, expressing his own prepotent personality and Egypt's military and economic preponderance in the Arab world and unquestioned leadership in the struggle against Israel. Since Nasser's death, the regime's Arab nationalism, too, has been moderated in consequence of Sadat's rather different personality, the more domestically oriented preoccupations of his government, the bigger role of Syria in the fight against Israel, and

the increasing importance of Saudi Arabia in the Arab world owing to its growing oil revenues.

Internally, the regime must cope with the central problem of many developing nations: too high a rate of population growth and too low a rate of economic growth. In Egypt's case, the difficulty is compounded by its limited arable area; once the additional land that can be irrigated by the Aswan dam has been brought into cultivation, no further expansion is possible. Inadequate agricultural productivity and the limited petroleum resources known until recently necessitated large imports of food and fuel, thereby absorbing the scarce foreign-exchange needed to finance capital-goods imports to expand industrial production. Moreover, the heavy outlays for military equipment and manpower, as well as the immense cost of the wars with Israel, and the servicing of Egypt's overseas debts have further restricted the resources available to the government for financing internal and external development expenditures. Finally, bureaucratic delays, poor management and the high prices of imports have caused shortages and increased inflationary pressures, leading to strikes and demonstrations.

Recently, however, the prospects for easing these economic constraints have brightened. It now appears that Egypt has substantially greater petroleum reserves than previously believed, and the reopened Suez Canal will soon be augmenting its foreign-exchange earnings. Saudi Arabia, Kuwait and other surplus OPEC countries are providing much increased financial assistance for both development and military purposes; indeed, Egypt is by far the largest recipient of such aid. If another war with Israel does not occur -- and even more so if a peace settlement is reached --

these favorable factors should enable the existing regime to overcome shortages, reduce inflation, and begin to make significant progress in mitigating the poverty, poor health, illiteracy, and other deficiencies of Egyptian society. In the long term, of course, substantial economic development is bound to lead to profound sociopolitical dislocations. But such destabilizing changes lie a decade or more in the future.

Thus, the continuation of Egypt's authoritarian military regime for at least the remainder of the 1970s has a high probability. Even if internal economic conditions do not improve significantly in the next few years, disaffection is unlikely to become sufficiently widespread and intense to permit the dissatisfied intellectuals and other opposition groups to organize the kinds of urban outbreaks that could overthrow the regime. More likely, such popular unrest -- or a disastrous defeat in a war with Israel -- would lead to the replacement of Sadat and his immediate colleagues by another clique within the military elite. And, if progress is made in coping with Egypt's socioeconomic problems, the stability of the authoritarian military regime seems assured for the next decade.

Saudi Arabia

At first glance, the Saudi-Arabian regime seems to be one of the most secure and stable in the Arab part of the region for both external and internal reasons.

As to the first, revolutionary agitation and hostile propaganda directed against the Saudi government by the nationalist-socialist states in the Arab world -- notably in the past by Nasserist Egypt -- have greatly diminished since the late 1960s. This can be attributed to three changes. One was the withdrawal of Egyptian troops from the Arabian peninsula and the formal recognition of the Republic of Yemen by the Saudi government, which neu-

tralized the Yemeni question as a point of confrontation between the nationalist and traditionalist factions in the Arab world. The second was the death of Nasser in October 1970, which deprived the nationalist faction of its most charismatic leader and King Faisal of his most powerful adversary. Finally, the Arab-Israeli conflicts of 1967 and 1973 enabled Saudi Arabia to strengthen its position in the Arab world by imposing an oil embargo against Israel's supporters and providing large amounts of aid to the Arab combatants both during and after these conflicts.

Internally, the Saudi regime has continued to enjoy the support of the traditional sector, which still includes a large majority of the population. King Saud was deposed in 1964 by the royal family without incident, and the armed forces and the major bedouin tribes shifted their support immediately to his brother Faisal. So far, there have been no significant manifestations of political instability, except for the minor effort at political reform by several of the younger Saudi princes, and an easily suppressed conspiracy by some air-force officers. Finally, the massive inflow of capital since the OPEC price rise in 1973-74 has provided the regime with immense revenues for accelerating internal development, as well as for assisting other Arab nations.

All of these factors give the impression that the Saudi regime will have little, if any, difficulty in maintaining its autocratic rule for the remainder of the 1970s and probably for the indefinite future. Nevertheless, if account is taken of the fragmented nature of Arabian society, the process of rapid sociocultural change, the almost total absence of a sense of national identity, and the religious basis of the sovereignty of

the Saudi family, a quite different picture emerges.

Both before Mohammed united the peninsula under Islam and after the Caliphate moved to Damascus, traditional Arabian society was severely fragmented, conscious of a common language, religion and other cultural elements but not of any institutional structure of unity. The society consisted of small autonomous agricultural and commercial settlements located mainly on the coasts or in the Hejaz surrounding the vast interior inhabited by independent nomadic bedouin tribes and seminomadic groups in process of settlement. The urban centers had little to do with the bedouins and vice versa. There was always considerable rivalry among the towns, and feuds and wars among the bedouin tribes were established behavioral norms. Turkish rule in the peninsula from the 16th to the 20th centuries was nominal outside the towns and did not involve the unified administration of the country. Political unity was only restored through a second jihad in the early 20th century, when the Saudi family and the followers of Wahhabism, a fanatical puritan sect, completed the conquest of most of the peninsula in 1926. The military campaigns were largely fought by a bedouin army of religious fanatics and, although it was eventually disbanded, the religious character it lent to Saudi rule persists.

Arabian society is still largely traditional and fragmented. The extended family and the tribe continue to be the major social units, commanding the individual's primary loyalty and imbuing him with a sense of identity. The lower classes -- the bedouin tribesmen, the peasants and settled herdsmen, and the laborers, artisans and bazaar traders in the towns -- are conservative and loyal to the heads of their families and their

tribal and local sheiks. The traditional elites, in whom political power and wealth have always been concentrated, consist today primarily of the very large Saudi family and its collateral branches and secondarily of the other noble bedouin chiefs, the wealthy town merchants, and the orthodox Moslem scholars and judges who interpret and administer the sharia, the Islamic law derived from the Koran. Institutionally, the unity of the traditional sector depends upon the Saudi monarch and the theocratic nature of his regime. The King has been both secular ruler and religious leader (Iman) and his rule has been legitimized by the sharia. If this traditional religious support of the Saudi monarch were to be undermined or removed, there would be no currently existing social institution or set of behavioral norms with which to replace it. But, the process of modernization inevitably involves secularization, which means erosion of the traditional religious basis of Saudi rule.

Until the 1950s, modernization was barely perceptible. Since then, as petroleum production and oil revenues grew, a modern sector gradually emerged within Arabian society. At first, it consisted mostly of immigrants from Egypt, Palestine and other more advanced Arab nations who supplied the clerical and manual skills needed for petroleum production and related economic activities and the technical and professional skills required by these new industries and by the expanding government bureaucracy and educational system. Thanks to the latter, as well as to attendance by growing numbers of Arabians at universities in Cairo, Beirut, Western Europe, and North America, increasing numbers of indigenous personnel have gradually become

available to staff the modern sector. Today, it consists of these modern-educated bureaucrats and military officers, managers and technicians in the oil installations and the new government-owned enterprises, businessmen (usually sons of traditional merchants), and skilled workers, as well as educators and other professionals. With the immense increase in petroleum revenues since 1973-74, the modern sector will grow at an accelerated rate during the remainder of the 1970s.

So far, these modern elites have not generally been restive under the autocratic rule of the Saudi monarch. Increasing numbers of them have gradually been admitted to the policy-making levels in the economic ministries, including cabinet posts. Nevertheless, the final decisions on important economic matters -- as well as in other fields of government policy -- continue to be made by the King and trusted members of the Saudi family. The question is how much longer will the modern elites be content to enjoy rising prosperity and increased economic responsibilities without also demanding a growing share of political power. Educated abroad, many members of the modern sector -- including many officers of the regular army -- have been exposed to radical Arab nationalist-socialist ideas and to Western political values and behavioral norms. These experiences are likely sooner or later to reinforce their own growing capabilities and self-esteem to the point of transforming their present acquiescence in the Saudi autocracy into mounting pressure for effective participation in the political process.

This possibility has been recognized by King Faisal, who has taken explicit steps to forestall or counteract it. Paralleling the regular armed forces, with their largely foreign-trained officers, is the national guard, of roughly equal size, manned and officered mostly by bedouins, and soon to be as well equipped with modern armaments and trained in their use by Americans brought to Arabia for the purpose. Moreover, much of the regular army's advanced equipment is kept in arsenals under direct royal control. In effect, the regular army assures the King's rule over the traditional sector, the national guard assures his rule over the modern sector, and each armed service assures his security against the other.

Nonetheless, the balance maintained by this "divide and rule" policy is essentially precarious. The danger is that it will collapse in both sectors, unleashing the disintegrative particularism inherent in a transitional society like that of Arabia. Among the leading possibilities are a contest for the succession among the princes or rivalry for political power among different factions or branches of the large Saudi family -- either of which would probably involve all or part of one of the armed forces in an attempted coup that would be resisted by the other. Or, regular army officers might act on their own with the support of disaffected members of the modern elites. Several of these possibilities could occur simultaneously or in consequence of one another. In any event, strife within the Saudi ruling family or a serious armed threat to its power could loosen its hold over the traditional sector, tempting ambitious bedouin sheiks to intervene in the political struggle on one side or the other and permitting age-old intertribal feuds to be resumed.

In other words, the nature of the transitional Arabian society makes the probability of peaceful evolution from autocratic Saudi rule to a more modern type of authoritarian regime at best only equal to and very likely less than that of complex and protracted civil strife encompassing much of the peninsula. Such a development would disrupt the economy, cut down or even stop the oil flow, and invite outside intervention. Thus, beneath its existing apparent political stability, Saudi Arabia is potentially one of the most unstable nations in the region -- one that will be increasingly liable to social unrest and perhaps civil war the faster its mounting oil revenues accelerate its socioeconomic development.

Iraq

If Saudi Arabia's political instability is latent, that of Iraq has been manifest. Since achieving independence, successive regimes have been periodically replaced through military coups or palace revolutions and, in the interims, the suppression of real or imagined conspiracies against them have been frequently announced. Since the overthrow of the autocratic Hashemite monarchy in 1958, Iraq has been governed by authoritarian coalitions consisting of one or more of the political parties allied with and supported by one of the rival groups of military officers. Since 1968, the civilian partner in the ruling coalition has been the nationalist-socialist Baathist Party.

Like Saudi Arabia, Iraq is not yet a national society with an emerging sense of distinctive national identity. Indeed, it has even lacked the high degree of cultural homogeneity that has characterized traditional

Arabian society. Open to invasion throughout its recorded history, Mesopotamia has always had a great deal of ethnic diversity. Nor, even in antiquity, was it an institutionally unified entity, as was Egypt. In the early millennia, individual city-kingdoms, such as Babylon, were often able to impose their rule over wide areas, and Mesopotamia's subsequent conquerors -- Persians, Macedonians, Iranians, Arabs, Mongols, and Turks -- governed it as a number of administrative subdivisions within their much more extensive empires. Its political unification began only with the British mandate after World War I and was continued under the alien Hashemite dynasty -- a ruling family from the Hedaz imposed by the British in part because of the particularistic rivalries among the possible indigenous candidates.

Today, the ethnic diversities of Iraq are still very great. The sophisticated urban population of Baghdad and Basra contrasts with the isolated subsistence marsh dwellers of the lower Tigris-Euphrates valley and the nomad tribes on the desert fringes. In between are the peasant cultivators comprising the bulk of the population. The Kurds, a large ethnic minority concentrated in the northeast, have been in more or less open revolt since the early 1960s. Nor does Iraq even have religious unity: the Moslem population as a whole is split between a numerical majority of Shiites and a minority of Sunnis who, however, predominate in the ruling Baathist/military coalition, the government bureaucracy, and the landowning and business groups. The antipathies -- sometimes the armed strife -- among Iraq's traditional tribes, sects and diverse ethnic groups are paralleled by the particularistic struggles for power and wealth among the country's modern elites of military officers, politicians, government bureaucrats, businessmen, professionals,

and intellectuals. Indeed, they compete in a highly charged atmosphere of intrigue, rumor, official surveillance, and often brutal repression that is unmatched elsewhere in the Arab world.

Despite the substantial oil revenues that Iraq was obtaining even before the quadrupling of petroleum prices in 1973-74, the country's economic development has been slow and erratic. Large financial resources have been devoted to the armed forces and the costly effort to suppress the Kurdish revolt, and much of the funds remaining for development purposes has been unwisely programmed, ineffectively expended or diverted to private benefit. Agricultural production has lagged badly. In some years, Iraq has had to import nearly half of its foodgrain consumption in part because so little has as yet been done to restore the irrigation system, destroyed by the Mongols in the 13th century, upon which Mesopotamia's previously high agricultural productivity had mainly depended. Some light industries and the beginnings of basic industries have been developed but the Baathist regime's socialist ideology has discouraged indigenous private investment and the inflow of capital and technology from the Western nations. However, the Soviet Union has been providing substantial amounts of military and economic aid, the latter mainly for infrastructure.

The need to divert popular and elite-group attention from Iraq's internal conflicts and deficiencies accounts in part for the nature of its external relationships. Regarded as one of the more radical members of the nationalist faction in the Arab world, the Baathist/military regime has alienated the other nationalist members by its truculent "holier-than-thou" approach, and it has been hostile to the traditionalist faction.

Iraq has sought to annex territory of its neighbor Kuwait and has been assisting revolutionary groups in the smaller emirates of the Persian Gulf. In consequence of its unpopularity, Iraq has had virtually no support from the Arab world in its serious difficulties with Iran. In addition to specific issues, such as the unsettled boundary along the Shatt al Arab and Iranian assistance to the Kurdish rebels, Iraq has been worried by Iran's steadily growing military strength and the Shah's efforts to succeed the British as the paramount power in the Persian Gulf. Yet, although Saudi Arabia is similarly concerned, the mutual antipathies between it and Iraq -- as well as the latter's designs on Kuwait -- have hitherto prevented a joint countereffort to Iran's expanding power in the Gulf.

Since the big increase in its petroleum revenues in the winter of 1973-74, there have been indications that the Baathist/military regime may be moderating its foreign policy and embarking on a more effective internal development effort. It may be that great wealth will be a sobering responsibility. If such a shift takes place, Iraq's relations with its Arab neighbors should improve and, in time, economic development could ameliorate the condition of the great mass of the people. Nevertheless, granted its cultural diversities, the highly particularistic nature of its traditional and modern social groups, and the precarious tenure of its civilian/military regimes, it seems likely that Iraq's sociopolitical instabilities will persist for at least the remainder of the 1970s. In turn, and regardless of whether the Kurdish revolt continues or not, these internal tensions could lead to or exacerbate conflicts with Iran and Iraq's other neighbors in the Northwest Indian-Ocean region.

India

India is too vast and complex and its economic and political problems too well known for its distinctive characteristics and prospects to be briefly sketched with the degree of comprehensiveness possible or necessary in the cases of the four preceding countries. Accordingly, the admittedly broader and more impressionistic generalizations presented here are intended only to illuminate the main outlines of India's basic sociocultural processes and their more or less probable effects on its internal stability and regional role.

The Indian subcontinent has been the historical home of one of the great civilizations evolved on this planet. In consequence, most of its inhabitants have a deeply ingrained sense of belonging to an all-enveloping and immemorial common sociocultural environment that, both in the past and today, embraces a multitude of different though related subcultures. Except briefly under the Moghul emperor Aurangzeb in the 17th century, India has been institutionally united only since the establishment of British rule over the subcontinent in the early 19th century. Due largely to that experience, India's elite groups today have a strong sense of national identity -- as well as of cultural identity -- which is shared in significant degree by much of the urban population but by only a small proportion of the rural population, still the great bulk of India's people.

Despite this spreading sense of national identity, India has a highly particularistic society owing to the wide cultural diversities and ethnic distinctions that have evolved within its common civilizational framework or have been incorporated within it through migrations, conquests and other forms of external contact. Indeed, India can be considered as the model of the divisive particularism of the transitional society. Internally, it is differentiated into a bewildering multitude of traditional

religions, sects, castes, tribes, ethnolinguistic regions, and racial minorities that in greater or lesser degree compete for income, status and political power or autonomy, sometimes by violent means. Moreover, this heterogeneity inherited from India's traditional past is further complicated by the differentiation resulting from the modernization process. On the one hand, the new modern elites of politicians, government officials, military officers, businessmen, educators, intellectuals, technicians, and skilled workers continue in some degree to share the values and behavioral norms of the traditional social units in which they participate. On the other, they are constrained to conform to the often incompatible ways of living and working necessitated by their involvement in modern occupations and by the compulsion to protect or advance their competing self and organizational interests. For these reasons, Indian nationalism is an effective integrating force for the old and new particularistic groups with respect to their country's relationships with the outside world but not yet in the internal relationships among them. In other words, Indian society still lacks a basic consensus on national goals and the means for achieving them that can sufficiently restrain and orient the pursuit of group and individual interests to give the nation's modernization efforts a decisive momentum in a consistent direction.

True, many other transitional societies in Asia and Africa are characterized by particularism fully as divisive as that of India. What makes India's problem unique is the sheer scale of the tasks that confront its ruling elites. The immense size of the population, the enormous losses inflicted by droughts and floods, the vast number of villages that have to be reached by development programs, the extremely low level of per capita income, the multitude of unemployed and under-

employed people, the monumental inertia of traditional attitudes and behavioral norms -- all compound the difficulties with which policy makers and civil servants must cope. At the same time, the abstract quality of traditional Indian thought and the personalistic and authoritarian character of traditional institutions predispose many modern-educated elites to accept doctrinaire ideologies, such as socialism, that involve implementation by detailed governmental decision making and administration rather than by the automatically pervasive incentives and pressures of the market process. Thus, India's ruling elites have chosen precisely the development strategy that is most difficult to carry out effectively given the enormous scale of the changes that have to be induced and the absence of a basic consensus that can sufficiently harmonize particularistic interests and provide the discipline of transpersonal motivation to a large enough number of people.^{3/} It is these compulsions and immobilities that make their significant developmental accomplishments during the 1950s and '60s all the more noteworthy.

^{3/} The question naturally arises as to the differences between India and China. Suffice it to note here China's much greater cultural homogeneity, its effective institutional unification for most of the past 2,000 years, its early and powerful sense of unique cultural identity and superiority, its ethic of social obligations covering all groups in the society, its centuries-old ideal of transpersonal public service by the educated elites, and the this-worldly orientation and practical concreteness of its predominant indigenous philosophy. The task of China's communist rulers has been much less difficult than that of India's ruling elites because, in essence, the former have only had to adapt to their own purposes the social cohesion, the relations of authority and subordination, and the transpersonal motivation and discipline inherent in traditional Chinese society and culture. Nor is it accidental that India's communists have split into three -- or perhaps four -- rival groups. For a historical sketch of the Chinese sociocultural background, see Theodore Geiger and Frances M. Geiger, Tales of Two City-States: The Development Progress of Hong Kong and Singapore (Washington, D.C.: National Planning Association, 1973) Chapter 11.

In recent years, a combination of natural disasters and unfavorable external economic developments -- notably the increased prices of imported fuel, food, fertilizer, and capital goods -- has led to local famines and more general setbacks in major development sectors that have lowered national morale and intensified particularistic rivalries among old and new social groups and the pursuit of self-interest by the modern elites. In turn, these psychopolitical reactions have further impaired the effectiveness of governmental efforts to cope with critical situations and regain lost developmental momentum.

India is one of only three Asian and African countries with an unbroken record of more or less free and regular democratic elections as the method for determining the tenure of office of political leaders and parties.^{4/} In India's case, the major reason has undoubtedly been the electoral predominance that the ruling Congress Party has hitherto enjoyed, especially at the national level -- although the effects of a century and a half of British education and example should not be minimized. Now, however, the interactions between the increasing severity of the problems confronting the nation and the intensification of its particularism could well undermine its democratic political institutions.

As India's economic difficulties have mounted and corruption and self-seeking have become more blatant at all governmental levels in recent years, electoral support for the Congress Party has been declining,

^{4/}The other two exceptions are Malaysia, in which -- as in India -- this crucial criterion has yet to be put to the test, i.e., the willingness of the ruling party to be voted out of office; and Sri Lanka, where parties have been voted out of office in the past but where the presently ruling leftist coalition may not be willing to submit itself to this test in the future.

particularly in the state governments. A few of the latter have been governed from time to time by coalitions of right-wing parties and Independents; in others, the Congress Party has been able to continue in office only in coalition with Independents and leftist parties, including communists; and in some, it has preserved power only by the imposition of "President's rule", that is, through an administration appointed and controlled by the Prime Minister in New Delhi. If and as popular support for the Congress Party continues to wane, neither its leadership nor its rank-and-file politicians are likely to be willing to yield to rival political parties -- particularly those ideologically to the right of them -- the executive and legislative offices that provide their political power, their social status and, above all, their personal incomes. Thus, there is now a significant probability that the Congress Party will become more and more authoritarian in the years ahead, perhaps to the point of suspending the constitution and ruling dictatorially with the support of the military. Such a trend would be facilitated by the more than threefold increase in expenditures on the internal security forces that has occurred in recent years.

These actual and incipient internal political pressures and uncertainties have also been stimulating a more pronounced effort on India's part to assure its external security by acquiring clear dominance over the smaller nations in the subcontinent. This is evident not only in the recent de facto annexation of Sikkim but more importantly in India's liberation of Bangladesh, which has become one of its client states, and

In its vehement objection to the resumption of U. S. military aid to Pakistan. In addition, India's achievement of a nuclear capability improves its military posture vis-à-vis China, emphasizes its military predominance over Pakistan, and increases its influence over its small neighbors. Finally, India's military and economic ties with the Soviet Union are as much a support to the former's paramountcy in the subcontinent as they are to the latter's policy in Asia.

Both the role that India plays in the subcontinent and its own internal exigencies are impelling it to a more active involvement in the Indian Ocean area and especially in the Northwest Indian-Ocean region, with which it has had close historical ties. Since antiquity, India has been a major trading partner of the commercial towns of the littoral and, until India became independent, British hegemony in the Persian Gulf was administered from India and enforced largely by units of the Indian army and navy. India now aspires to eventual naval supremacy in the Indian Ocean, from which it seeks to induce the United States and the Soviet Union to remove their forces. Today, growing numbers of Indian technicians and advisers are serving in the small states of the Gulf as their oil revenues increase. In turn, India is obtaining petroleum from some of the Gulf producers at concessionary prices, it has entered into long-term supply contracts with Iraq and Iran, and it is receiving development loans from Iran, Saudi Arabia and other surplus OPEC nations. The possible significance of India's increasing role in the Northwest Indian-Ocean region will be assessed in a later section.

The Soviet Presence

Over the past decade, the Soviet Union has become an active participant in the affairs of the Northwest Indian-Ocean region. The Soviet presence is manifested in four ways: the naval force stationed in the Indian Ocean, military aid, economic and technical assistance, and more intensive diplomatic activity.

The Soviets maintain an Indian-Ocean naval force of approximately six surface combatants, one submarine, and eleven support ships. Both the average number of ships and the amount of time they spend in the area have increased steadily since the mid-1960s.^{5/} The Soviet fleet has access in a limited manner to the following facilities in the region:^{6/}

1. Southern Yemen: port facilities and airfield at Aden.
2. Iraq: port facilities at Um Qasr.
3. Somalia: port facilities at Berbera and airfield at Mogadiscio.
4. India: ports open as they are to other nations.
5. Bangladesh: limited bunkering at Chittagong.
6. Socotra: anchorage except during monsoons.
7. Chagos Archipelago: anchorage.

The first three ports are potentially the most important; after appropriate development, they would give the Soviet Union a permanent naval

^{5/} "Statement of W. E. Colby, Director of Central Intelligence Agency," before the Subcommittee on Military Construction of the Committee on Armed Services of the U. S. Senate, July 11, 1974. (GPO, Washington, D.C. 1974), pp.161-162.

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1 through 5 from: "Testimony of Rear Admiral Charles D. Grajean, Office of the Chief of Naval Operations" before the Subcommittee on Military Construction of the Committee on Armed Services of the U. S. Senate, July 11, 1974. (GPO, Washington, D.C.: 1974) p. 150. 6 and 7 from: "Colby Statement," cited, p.163.

capability in the Indian Ocean concentrated around the Arabian peninsula and, along with the facilities at Alexandria, able to threaten both entrances to the Red Sea.

Prior to 1965, Soviet military assistance was minimal but thereafter it grew steadily -- first to Egypt and India and later to Iraq, North and South Yemen, Somalia, and the Sudan. Similarly, large amounts of Soviet economic aid and technical assistance have gone to India and Egypt since the early 1960s and more recently to Iraq, Somalia and the two Yemens. The provision of large-scale military and economic assistance involves heightened diplomatic activity in the recipient countries, thereby tending to strengthen the close political relations which the Soviet Union has had with India, Iraq and, until recently, Egypt.

This growing Soviet involvement in the region -- physically, economically and diplomatically -- resulted from three converging trends in Soviet perceptions and conceptions.

The first was the Soviet Union's changing conception of its security needs. During the 1950s and early 1960s, the Soviet Union was trying to catch up with U. S. nuclear power. However, when parity seemed attainable, the United States developed its Polaris/Poseidon capability, which gave it a decisive strategic advantage in terms of deployment and first-strike invulnerability. Thereby, it lent support to those leaders in the Soviet Union who argued for an offensive naval capability and under whose influence the formerly defensive Russian navy was increasingly rebuilt around submarine and antisubmarine units primarily designed

to counter U. S. nuclear superiority. Then, the presence of the U. S. 6th and 7th Fleets in positions tactically disadvantageous to Soviet efforts to expand its influence beyond the nations immediately adjacent to its borders led to the development of Soviet missile-carrying surface vessels by the late 1960s. This new Soviet fleet was gradually deployed in the Mediterranean Sea and the Pacific and Indian Oceans not only to balance U. S. naval forces but also to enhance Soviet prestige and support its diplomatic initiatives in -- among other nations -- the Arab states and India.

The second trend consisted of these Soviet diplomatic efforts in the Arab nations. It is beyond the scope of this chapter to discuss in detail the origins and nature of Soviet policy in the Mediterranean region and West Asia generally. Suffice it to say that, by the mid-1960s, an active policy did exist and involved a substantial commitment of military and technical aid. An important contributing factor was the Soviet compulsion to counterbalance the perceived threat to its southern flank believed to arise from the formation of the U. S.-sponsored CENTO. In response, the Soviet Union strengthened its relations with friendly regimes on the far side of CENTO's members, i.e., of Turkey, Iran and Pakistan. Then, the Arab-Israeli wars of 1967 and 1973 brought the Persian Gulf area within the purview of the Arab-Israeli conflict by, in effect, politicizing the petroleum resources of the Arab nations along the littoral. This development impelled the Soviet Union to extend its diplomatic efforts into the Gulf so as to maintain its influence in Arab policy making. At the same time, the civil wars in North and South Yemen

and the changes of regime in Iraq and Somalia were also leading the Soviets into deeper involvement in the Northwest Indian-Ocean region. Finally, the extreme dependence of Japan and Western Europe on regional oil supplies and the beginning of U. S. dependence certainly helped to propel Soviet policy further along these lines. Thus, the Soviet presence in the region today has not been owed to the formation of a new policy but rather to the logical extension of an old policy.

The third trend was the Soviet effort to gain influence in India, initially undertaken as part of its attempt to counterbalance U. S. support for CENTO, and thereafter largely in response to the threat it perceived of Chinese expansionism in Siberia and in South and East Asia. Granted India's size and its sense of psychocultural independence and international importance, it is unlikely that any amount of Soviet pressure or aid could have reduced India to a client state, as many Americans feared. Rather, the fact that both countries were alarmed at the possibility of Chinese expansion provided a firm basis for cooperation and a sound rationale for a build-up of Indian power through Soviet aid. As noted in the preceding section, Soviet military assistance was also sought by India as a means for achieving predominance in the subcontinent.

These three trends gradually merged to constitute the regional policy that the Soviet Union is now following and will probably continue to pursue for the remainder of the 1970s. Its present and prospective characteristics may be briefly delineated.

First, the Soviet Union will continue to try to increase its influence in the region essentially for three reasons. The Soviet Union is naturally concerned to prevent direct access to its own southern flank by any potentially hostile power, and hence it attempts to assure not only that the neighboring states have friendly regimes but also that they are strong enough to survive. It is also interested in the region's rich natural resources as a present and future source of supply for its own growing needs. And, in a long-term perspective, the Soviet Union envisages the eventual establishment of communist regimes in this region as in other parts of the world.

Second, furtherance of these objectives does not necessarily involve establishment of a Soviet hegemony over the region, like that of the British in the early decades of the 20th century. Nor does an hegemonic effort by the Soviet Union have a significant probability during the remainder of the 1970s. Not only would it be resisted by the United States but also the Soviet Union is unlikely to be willing to expend the military and economic resources required to enforce an hegemony even in the absence of U.S. opposition. For, the larger nations of the region have by now acquired sufficient economic and military capabilities of their own and are so intent upon preserving their independence that they probably would be able to make the cost of establishing and maintaining a Soviet hegemony too great for the latter.

Third, the Soviet Union will probably continue to expand its naval presence in the Indian Ocean both to counterbalance the U. S. air and naval capability and to raise its prestige with and support its diplomatic activity in the regional nations. In view of the U. S. construction on Diego Garcia

and the intended U. S. use of the British facilities on Masirah, the Soviet Union is likely to develop at least one naval base, perhaps in Berbera or Aden.

Fourth, the Soviet presence in the Northwest Indian-Ocean region is and will continue to be both stabilizing and destabilizing -- a characteristic ambivalence of superpower relations in the present period as explained in Chapter I. On the one hand, Soviet influence with the friendly nations in the region was in many cases originally established by helping radical nationalist-socialist regimes to seize and consolidate power, and it will undoubtedly try to stimulate and aid such developments in the future. On the other hand, now that its ties with these regimes exist and their cost is measured in billions of dollars of military and economic aid, the Soviet Union is impelled to foster stability not only within these nations -- uncertain as that is in transitional societies, as pointed out in the preceding section -- but also in their relations with one another. Thus, the Soviets could not prevent the 1973 War, though they opposed it, and the united Arab outcry over the Iraqi aggression against Kuwait caused them considerable embarrassment.

In sum, the Soviet Union will continue to maintain a presence adequate to insure the support of its existing commitments and sufficient to exploit any situation that could alter in its favor either the balance of power in the region or the nature of the regimes in the constituent nations. At the same time, it will seek to maintain stability in a region to whose instabilities its own activities have contributed in the past and will continue to contribute in the future.

Prospective Intraregional Instabilities

Regardless of whether or not they are fostered by the activities of the Soviet Union, important instabilities are likely to arise in the relations among the nations comprising the Northwest Indian-Ocean region in large part because of the basic sociocultural changes occurring within them. However, the concept of instability is used here in a different sense than in the analysis of these internal sociocultural changes in the first section of this chapter. In the regional context, it refers to the occurrence both of major armed conflicts among the constituent nations and, more broadly, of actions by one or more of them that could upset the delicate internal balance in another country -- in either case encouraging outside intervention and severely disrupting economic relations, especially the flow of oil, between the region and the rest of the world. Obviously, such instability can result from the actions not only of a country or group of countries within the region but also of an outside superpower operating directly or through its regional allies.

The focus, then, of this section is on the more and the less likely instabilities that could be generated by the interactions among the nations of the region with and without the intervention of the superpowers. No single prospective pattern of interactions is discernible; rather, there are a number of possible patterns, any two or more of which could occur simultaneously or sequentially and which, if they did so, would undoubtedly significantly modify one another. Six possible patterns of interactions are projected:

1. - Internal disorder in Saudi Arabia.
2. - Iraqi provocation of its neighbors.
3. - Iranian efforts to achieve paramountcy.
4. - Disintegration in Pakistan.
5. - Indian expansion into the Persian Gulf.
6. - Internal disorder in the Persian Gulf Emirates.

Before turning to these possible patterns of disruptive interactions, however, an explanation needs to be given as to why another Arab-Israeli war or a peace settlement of some kind would not alter them fundamentally. None of the more and the less probable patterns of regional interactions analyzed below depend for their origin and development upon the relationship between Israel and its Arab neighbors. The only significant way in which that relationship could affect them would be with respect to their timing. That is, so long as the probability of another Arab-Israeli war is high, it tends to inhibit -- but not to prevent -- the emergence of those patterns of interactions whose inception depends upon the initiative of an Arab country. Conversely, if some sort of settlement were to be reached between Israel and the Arabs, this restraint would be removed, and the relevant patterns of interaction would tend to get under way sooner rather than later. Thus, although the probability of their occurring during the remainder of the 1970s would be affected by developments in the Arab-Israeli relationship, the nature and likely effects on regional stability of these six possible patterns of interactions would not be substantially altered.

Internal Disorder in Saudi Arabia

The transitional nature of Arabian society and the acceleration of the modernization process by the greatly expanded petroleum revenues will be increasingly likely with each passing year to lead to internal disorders of one kind or another. The precise forms that these prospective disorders will take cannot be foreseen. Among the main possibilities, however, are struggles among rival princes or groups within the large Saudi family, military coups by the regular army or the national guard supported respectively by the modern elites or the bedouin tribes, and, most probable, some combination of the foregoing -- with any or all of these possibilities likely to develop into a protracted peninsula-wide civil war. By disrupting the production and export of petroleum and attracting the intervention of other regional states and of the superpowers, such developments in Saudi Arabia would have a profoundly destabilizing effect in the region.

The perceptual and conceptual biases and the conflicting interests of the regional states most likely to be involved and of the superpowers would constrain them to interpret internal disorders in Saudi Arabia as essentially conflicts between traditionalist and modernizing forces. And, needing outside military and financial aid, the Arabian contestants would tend to take on such identifications even though they may not have had them in mind originally. Hence, Egypt, Iraq, Syria, and South Yemen, along with the Soviet Union, would soon find themselves supporting one

side, and Iran and perhaps Kuwait and Jordan the other. For, despite the current competition between Iran and Saudi Arabia for paramountcy in the Gulf, the Shah would hardly be willing to see a traditionalist rival, like King Faisal, replaced by a presumably nationalist-socialist regime that would be much more hostile and aggressive. In such circumstances, Iran might be tempted to occupy the oil fields and perhaps the small neighboring emirates, an action that would be made possible by its growing naval and military capabilities. For its part, Iraq would be likely to intervene on the side of the nationalist-socialist forces, especially if Iran were to occupy portions of the Arabian coast, and the nationalists would undoubtedly be helped to resist by Egyptian and Syrian arms and probably troops. Regardless of how serious such competing interventions by the neighboring states might be, internal disorder in Saudi Arabia would pose highly complex and ambivalent policy choices for the United States that are discussed in the next section.

Iraqi Provocation

Recently, the Baathist/military regime in Iraq has been trying to moderate its previously strained relations with its Arab neighbors -- including even Saudi Arabia, to which it has hinted at the possibility of joint naval development to counter Iran's growing naval predominance in the Persian Gulf. Towards Iran, however, Iraq is still deeply suspicious and hostile: efforts to settle the Shatt-al--Arab boundary have once again broken down, armed clashes continue to occur between Iraqi forces trying to suppress the Kurdish rebellion and Iranian air and

ground units, and Iraq is strongly opposing the expansion of Iranian influence in the Gulf.

Hitherto, both nations have restrained their reactions whenever such frictions threatened to erupt into full-scale fighting. But, in view of the volatility of the Baathist/military regime in Iraq, the possibility of a serious conflict with Iran cannot be discounted. The repeated palace revolutions and military coups of the past mean that there is at least a 50-50 chance that the existing Iraqi government will sooner or later be replaced by another combination of factions in the Baathist Party and the armed forces. And, precisely because the existing ruling group is trying to institute more moderate policies, its successor would be likely to adopt a more radical nationalist-socialist line. In turn, such a shift would increase the probability not only of a serious conflict with Iran but also of renewed Iraqi moves against Kuwait and a resumption of provocative behavior toward Saudi Arabia. Any or all of these developments would have important destabilizing effects in the region.

Iranian Paramountcy

Conversely, heightened intraregional instability could be initiated by Iranian actions. The Shah has openly expressed his intention to make Iran the paramount power in the Persian Gulf -- in effect, inheriting the former British hegemony. To that end, Iran seized the Tunbs and Abu Musa Islands in the Strait of Hormuz, despite the vigorous protests of Saudi Arabia, Iraq and the small Arab emirates; and the planes and troops

Iran has sent to Oman to help suppress the Dhofar rebellion are enabling it not only to develop its power on the south shore of the Strait but also to establish a virtual protectorate over that country. In addition, the Shah is rapidly expanding Iranian surface and underwater naval capabilities and is buying long-range military aircraft that would make it possible for Iran to extend its power into the Indian Ocean proper. The Shah's recent visit to many of the nations around the Indian Ocean littoral indicates that he envisages Iran as playing an increasingly active and important role in the politics and economics of the entire area.

So far, the Shah has moved cautiously and skillfully toward achieving paramountcy in the Gulf and extending Iranian power into the wider reaches of the Indian Ocean. Neither the overt seizure of the Tunbs and Abu Musa islands nor the intervention in Oman has provoked a forcible reaction from Iraq or Saudi Arabia, whose own interests were perceived as adversely affected thereby. Nevertheless, the possibility cannot be discounted that future expansionist moves by Iran might be miscalculated, leaving Iraq and/or Saudi Arabia with the conviction that it or they had no choice but to retaliate. In any event, a major armaments race is already under way in the Gulf that -- however helpful it may be to the United States and Western Europe in coping with their balance-of-payments and employment problems -- inevitably increases the likelihood that conflicts of interest and ambition would sooner or later involve the use of force.

Nor are the Arab states of the Gulf the only nations that could be embroiled in serious conflicts with Iran in consequence of the latter's expansionist policies. India, too, would be likely to become concerned in proportion to the increase in Iranian naval capabilities in the Arabian Sea. Despite Iran's support of Pakistan and India's of Afghanistan, the two nations have in recent years been improving their direct relationship in consequence of their joint interest in limiting -- and if possible in removing -- the superpowers' forces in the Indian Ocean and of India's need for Iranian oil supplies and development loans. Also, India is one of the leading sources from which the Shah would be able to buy or otherwise obtain nuclear technology and eventually at least a regional nuclear military capability. Nevertheless, the expansion of Iranian air and naval forces into the Arabian Sea and southward into other parts of the Indian Ocean would probably alarm India for the security of its new-found petroleum resources in the Bombay High. And, India might also perceive the approach of Iranian power to its shores as a possible threat both to its own hegemony in the subcontinent and to its prospective naval supremacy in the Indian Ocean, if and when the superpowers withdraw from the area.

Disintegration in Pakistan.

Confrontation between Iran and India could be generated not only by possible Iranian expansionism -- or by Indian expansionism as discussed below -- but also by serious political and economic disintegration in Pakistan.

The 1970s have been an unusually difficult period for Pakistan. It has had to bear the defeat by India, the liberation of Bangladesh, the collapse of the military regime, the rebellion in Baluchistan, unrest in the Northwest Frontier Province, the upsurge of particularistic political and religious conflicts in the two most populous and developed provinces of the Punjab and Sind, natural disasters, the defects of the great Tarbela Dam, and the mounting prices of imported fuel and food. Pakistan's losses and internal weaknesses have given India a clear predominance in the subcontinent, making even more remote the possibility of increasing its share of Kashmir. The coming to power of a radical-nationalist, pro-Soviet regime in Afghanistan has turned that country into a more actively hostile neighbor, which supports the rebellions in Baluchistan and among the Pathans of the Northwest Frontier Province. Probably only the charismatic personality and political skill of Bhutto have held the nation together in the face of these major setbacks. Even so, Bhutto has felt impelled to suppress the leading opposition party and to rule in as authoritarian a manner as possible.

At the same time, Pakistan's prospects for the future are not necessarily as dim as its recent past. Its potential for agricultural and industrial development is good provided natural disasters do not occur too frequently, the irrigation system can be completed and functions effectively, and policies conducive to growth can be agreed upon and implemented efficiently. Next to Egypt, Pakistan is the favored recipient of aid from the Islamic members of OPEC. It continues to obtain political support and military assistance from its ally, China,

and it has a close relationship with its Moslem neighbor, Iran, which also is interested in preventing the spread of the rebellion from Baluchistan to its own contiguous Baluchistani minority and in countering Afghan efforts to foment unrest elsewhere in its eastern border regions.

Thus, the outlook for Pakistan is at present highly uncertain. The chances are probably better than even that the nation will continue to hold together, suppress or contain its internal disorders, and begin once again to realize its developmental potential. Nevertheless, India will carefully watch its revival, and -- as indicated by India's vigorous objection to the resumption of U. S. military shipments and aid to Pakistan -- will very likely endeavor to prevent it from again becoming strong enough to contest Indian predominance in the subcontinent. And, there is still a significant probability that Pakistan will not be able sufficiently to master its internal problems. Hence, the possibility cannot be discounted that Indian hostility, Afghan intrigue, rebellions, economic difficulties, and particularistic conflicts would lead to a disintegrative spiral in Pakistan. In such circumstances, not only would a confrontation of Iran with India and Afghanistan be likely to occur but also the Soviet Union, China and the United States would probably become involved.

Indian Expansionism

India's determination to dominate the subcontinent reflects both concern about its external security and the internal pressures generated by its divisive particularism, economic deficiencies and declining national

morale. As the Congress Party regime becomes increasingly authoritarian at home, it could also become more actively expansionist abroad to distract popular and elite-group attention and to augment its resources. Beyond the subcontinent itself, there is only one area into which Indian influence could expand that is accessible to its diplomacy and military power, which has rich and readily developed resources, which is not already so densely populated as to be a liability and not an asset, and over which it would not be likely to become embroiled with China or the Soviet Union. That is the southern shore of the Persian Gulf, including Oman. Hence, if and as India is impelled to follow an expansionist policy beyond the subcontinent, it would be westward into one or more of the small emirates bordering on the Persian Gulf and its approaches.

As explained in an earlier section, India has centuries-old ties with these states including not only trade but also military presence during the period of the British hegemony. Today, India is receiving concessionary oil and development loans from some of the Persian Gulf states and, in turn, has been providing technical assistance personnel -- although not, of course, as many as Moslem Pakistan. Building on this basis, India could steadily increase its economic role in one or more of the small emirates. An opportunity to station an Indian military force there could arise from internal disorder in the emirates or a request for military assistance to resist actual or feared encroachments by Saudi Arabia, Iran or Iraq. The process of increasing Indian influence might be sufficiently subtle and slow to prevent Iranian or Saudi Arabian interference, as well as U. S. intervention, until de facto

Indian control were already established. However, if India were to embark on such a course of expansion, a confrontation with Iran and/or Saudi Arabia would sooner or later occur that would very likely also involve the United States.

In present circumstances, the probability is low that India's ruling elites would seek directly to establish Indian control over one or more of the emirates. But, they will undoubtedly foster the continued growth of India's relations with and influence in the Persian Gulf area -- developments that could lead to competitive, if not conflicting, interactions with Iran and Saudi Arabia. And, if its internal instabilities and pressures intensify, it is within the limits of the possible that India would be impelled to augment its resources and distract popular attention from its domestic deficiencies by attempting to exercise control over one or more of the oil-rich states of the Arabian peninsula.

Internal Disorder in the Emirates

The small emirates of the Persian Gulf -- Kuwait, Qatar, Bahrain, the seven tiny states comprising the United Arab Emirates (UAE), and Oman -- are potential sources of intraregional instability not only because of possible rivalries among the larger nations of the region but also because of disorders that could arise within them. Kuwait, Qatar and Bahrain have been fairly stable in recent years; the main instabilities have been in the UAE and Oman.

Both still have largely traditional societies in which sociocultural change was very slow until the discovery and production of petroleum

within the last few years. Yet, even as traditional societies, the small towns and oases comprising the seven UAE states have not had much political stability. Five of their seven existing rulers, as well as the present Sultan of Oman, attained power through palace revolutions. Tribal and family feuds are endemic, as throughout the traditional sector of the Arabian peninsula, and armed conflicts have occurred in the recent past between UAE states and with Saudi Arabia and Oman over control of particular oases and other problems. Finally, a rural rebellion has been under way in Dhofar, the western province of Oman, that in origin was a separatist tribal effort but which soon became equated to a traditionalist-nationalist struggle, involving the military participation of Iran and aid from Saudi Arabia on the one side and support from South Yemen, China and the Soviet Union on the other.

This development foreshadows the ideological character that future unrest in the emirates, as in Saudi Arabia, will inevitably acquire regardless of whether it originates in the traditional or the modern sector. As the increase in oil revenues accelerates the modernization process in the towns, urban unrest will undoubtedly grow, thereby reinforcing the instabilities inherent in the traditional sectors. And, because of the importance of the petroleum resources, the more serious the internal disorders in the emirates, the more likely they are to attract the intervention of Iran, Saudi Arabia and Iraq -- and, in the circumstances noted earlier, perhaps even of India. In turn, such interventions would involve the superpowers.

Implications for U.S. Policy

Thus, in addition to the Arab-Israeli problem there are at least six other more or less probable patterns of destabilizing interactions that could occur within the region in the foreseeable future. Their consequences both for the regional nations involved and for the superpowers are likely to be all the more serious as the quantity and sophistication of the armaments available to the former increase. Moreover, the armaments race includes the possibility that not only India but probably also Pakistan, Iran and Saudi Arabia, as well as Israel and Egypt, will eventually be able to buy, develop or otherwise acquire nuclear weapons with at least a regional delivery capability.

The analysis in this chapter has endeavored to make clear that the basic internal sociocultural changes occurring within the nations of the region are the root causes of the existing and prospective instabilities in the relationships among them. True, as pointed out earlier, the activities of the two superpowers in the region have both destabilizing and stabilizing effects. But, they play these ambivalent roles only because the indigenous developments provide them with the opportunities to do so. In the absence of prior superpower involvement, such internally generated instabilities would continue to arise anyway, and would in some cases attract the post facto intervention of the Soviet Union or of the United States irrespective of the rivalry between them. Conversely, the two superpowers are incapable even of mitigating substantially, let alone of eradicating, the underlying causes of instability within and among the nations of the region -- only the latter's own progress in completing their transitional processes can do that.

The nature of the Soviet interest in the region was sketched in an earlier section. As for the U.S. interest, it consists -- in addition to the U.S. commitment in Israel -- of the need to assure ready and secure access to the natural resources of the region, especially the petroleum on which its European allies and Japan are overwhelmingly dependent and on which its own dependence has been significantly increasing. Other than this dependence, the United States has no vital interest in the region, although it has some important interests, such as the unimpeded flow of commerce, the fair and equitable treatment of U.S. private investment, the discouragement of nuclear proliferation, the fostering of socioeconomic development, the alleviation of the sufferings caused by natural disasters and social disorders, and others.

Protection of the vital U.S. interest in the region's resources certainly involves preventing direct or indirect Soviet control over them. But, as explained above, neither today nor during the remainder of the 1970s is the possibility of Soviet control likely to be the main danger. The only major threat to the vital U.S. interest that has so far arisen has been the oil embargo of 1973-74, which neither was instigated by the Soviet Union nor depended upon Soviet participation, assistance or even encouragement. Therefore, in the years to come, U.S. policy must not be formulated -- as it has tended to be too often in the past -- predominantly in terms of Soviet capabilities and possible intentions, nor implemented mainly by relationships with the regional nations that are dominated by security considerations and military sales and aid. The first disregards the basic sources of regional instabilities and the second is insufficient

by itself to protect the vital U.S. interest and may in some circumstances be counterproductive.

For these reasons, it is essential for the United States to interpret the significance of developments in the region and to devise its own policies regarding them in a broader conceptual framework that is relevant to the root causes of regional instabilities and takes adequate account of the nonmilitary dimensions of U.S. relationships with the nations involved. This alternative way of thinking about the U.S. role in the Northwest Indian-Ocean region would involve the following general guidelines:

1. The United States should endeavor to establish as friendly relations as possible with all of the countries of the region. This means essentially moving from partisanship to neutrality among the regional nations. True, such a shift is limited by the U.S. commitment in Israel and the future development of Arab-Israeli relations. Nevertheless, much can be done within this limitation to achieve a more even-handed posture with respect to regional interactions that do not relate to Israel. In the kinds of intraregional instabilities projected above, such a posture would enhance the ability of the United States to mediate among contending countries, to restrain the expansionist impulses of the larger nations, and to reduce the influence of the Soviet Union in the nationalist-socialist states, thereby making it more amenable to informal understandings to limit superpower involvement and perhaps even to joint efforts to preserve or restore peace. In this way, the United States would be in a better position to help contain -- and perhaps even resolve -- conflicts among the nations of the region, and it would not be so deeply committed to particular regimes within them that the latter's overthrow or replacement would preclude continued satisfactory relations with the new governments.

2. The countries with which U.S. relations need particularly to be improved if it is to achieve a more neutral posture in the region are Egypt, Iraq and India. As to the first, U.S.-Egyptian relations have changed significantly for the better in the last few years as the Sadat regime has sought to reduce its dependence on the Soviet Union and to utilize U.S. influence on Israel to obtain more favorable truce terms from that country. Iraq is a more difficult case, but the current apparent moderation of the Baathist/military regime may provide an opportunity to begin to make significant progress. The U.S. relationship with India is the most perplexing of all because the essence of the problem is psychocultural and not political and economic. During the 1950s and early 1960s, unrealistic expectations and irrational resentments were generated on both sides, reflecting on the part of the United States the excessive and directive participation of its citizens in Indian development efforts and on India's part its dependence on U.S. aid and the real and imagined impairment of its self-confidence and freedom of action thereby involved. Resolution of this too close and increasingly conflicted relationship required a period of distance between the two nations that may by now, or will soon, have sufficiently allayed the emotional content to permit a more constructive approach to develop on both sides. For the United States, such an approach would combine empathic understanding of and nondirective help for India's problems with reasonable firmness in protecting its own interests and as "low a profile" as possible within the subcontinent.

3. One major complaint against the United States not only by nations, such as India, with which it is trying to improve relations but also by those, such as Iran, with which it already has reasonably satisfactory ones is the U.S. military presence in the Indian Ocean. Granted the uncertainties regarding the future flow of petroleum supplies, the United States cannot now suspend its announced plans to develop Diego Garcia and utilize the British facilities on Masirah. Such actions would very likely be interpreted by the regional nations, as well as by the Soviet Union, as a signal that the United States had little, if any, interest in future developments in the area. But, permanently stationing a U.S. fleet in the Indian Ocean or expanding the air and naval facilities significantly beyond presently contemplated levels would be unnecessary and counterproductive. As during the Indo-Pakistani War in 1971, any desired reinforcement of the U.S. naval presence in the Indian Ocean could quickly be effected by sending units from the Pacific fleet and, after the Suez Canal is open, perhaps from the Mediterranean fleet as well. Expansion of the U.S. military presence would be likely both to provoke a corresponding increase in the Soviet presence and unduly to alarm India, Iran and other regional nations.

4. The problem of the arms race is much more complex and difficult to resolve owing to the constraints on both the suppliers and the buyers. Balance-of-payments problems resulting primarily from high oil prices and the unemployment caused by the recession combine to impel the United States and Western Europe not simply to accept armament orders from the regional nations but actively to seek and to compete for them. For their part, the regional nations are neither willing to reduce their petroleum prices sufficiently to ease U.S. and European payments problems nor able to sup-

press the internal pressures and the external ambitions and anxieties that underlie their escalating armaments race. In these circumstances, a unilateral reduction or cessation of U.S. arms shipments would be likely to be offset by increased sales by the West European nations and probably by the Soviet Union as well. Thus, the only possibility for limiting, if not terminating, the armaments race would be an understanding among the United States, the West European nations and the Soviet Union to restrict the quantities and kinds of weapons they would ship to the regional nations in the next few years. Although the probability of reaching such an agreement is not very great, the United States needs to make the effort to achieve it for both practical and moral reasons.

5. Another Arab-Israeli war, any of the destabilizing patterns of regional interactions projected in the preceding section, or some other development could lead the Arab nations to impose a new oil embargo against the United States with attendant reductions in petroleum shipments to Western Europe and Japan. During the remainder of the 1970s, additional sources of petroleum and alternative forms of energy are unlikely to be available in sufficient quantities to offset that loss. In such circumstances, opinion leaders and others in the United States will again urge that the Persian Gulf oil fields be seized by force. The oil fields on the southern shore of the Persian Gulf could probably be captured without too much difficulty if sufficient force were applied, and a sizable volume of production could probably be restored within months despite initial destruction. But, seizing and holding the pipelines to the Mediterranean would cost far more in men and money than the American people would be willing to endure. Nor could the Israelis be of much help; any force they sent

Into the Nafud and Syrian Deserts to help hold the pipelines would be much too vulnerable to flank attacks. Hence, the shipment of oil would be by sea, even though Egypt would undoubtedly close the Suez canal again and it is possible that efforts to mine the Strait of Hormuz would be made by one or more of the regional nations, with or without Soviet help. If U.S. armed intervention were sufficiently powerful, determined and supported by American public opinion, the Soviet Union would be unlikely to intervene directly. Nonetheless, the U.S. action would undoubtedly put an end -- at least for a time -- to the detente with the Soviet Union and would worsen relations with China. More important, the United States would again incur the hostility of all the nationalist-socialist nations in the region, and would probably also impel Iran, fearful for its own security, to move closer to the Soviet Union. Not only would the U.S. action alienate most other developing countries but also the West European nations, Japan and Canada would probably disassociate themselves from it, even though they would benefit from it, for reasons explained in Chapter II. Thus, the United States would be virtually isolated in the international system. For this reason, the United States would need to weigh very carefully whether the gains of forcibly seizing the oil fields would be worth the costs.

6. Because of the vital U.S. interest in the Persian Gulf oil resources, the prospective pattern of intraregional instability that would generate the most compelling pressures for U.S. intervention would be internal disorder in Saudi Arabia along the lines projected in the preceding section. As soon as ideological identifications crystallized in such an outbreak, prior commitments and perceptual and conceptual biases

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would strongly impel the United States to support and aid -- and perhaps physically to intervene on the side of -- the traditionalist elements. Such U.S. assistance and possible intervention would reflect short-term expediency because, in the end, the United States would only be identifying itself with a lost cause. Sooner or later, the modernizing elements in Saudi Arabia are bound to triumph and, for this reason, the United States needs to assess its options in a longer-term perspective. When it does, and if a neutral posture is ineffective in assuring the vital petroleum supply, the alternative of favoring the modernizing forces becomes not only feasible but also desirable. True, if the traditionalist forces were nevertheless to win, they would be hostile to the United States -- but they could neither shut off the oil for very long, since their need for funds would be great, nor allow their assets in the United States to be sequestered. Admittedly, these same considerations would also influence the modernizing forces if they were to win while the United States supported the traditionalists. In that case, however, not only might the interruption of the oil flow be longer but, more important, the United States would have alienated the other Arab states, lost its position as arbiter between them and Israel, and probably endangered the detentes with the Soviet Union and China. Conversely, under the alternative policy, the United States could substantially improve its relations with the Arab countries -- perhaps even to Israel's benefit -- and would be reaping the advantages of acting in accordance with the most probable future developments rather than paying the eventual costs of trying to resist them.

7. There will undoubtedly be objections in the United States to limiting its role in the Northwest Indian-Ocean region to a neutral and "lower-profile" presence. Yet, as explained in Chapter I, the superpowers no longer have a determinative influence in the international system, especially in situations where not only their military but also their economic power cannot be used or where employing these means of policy would involve greater losses than gains or would be more costly than their people would be willing to bear. Failure to adjust to the realities of the period of the new nationalism would mean in the Indian Ocean region the over-extension of U.S. resources in operations predestined either to eventual failure or to unintended escalation. Partisan involvement in intraregional disputes would limit U.S. influence and hamper the protection and advancement of the vital U.S. interest over the longer term. Thus, in the present and prospective circumstances of the Northwest Indian-Ocean region, a neutral and reasonably "low-key" role would be the best long-run policy for the United States.

The World Petroleum Situation: Demand, Supply and Price Prospects

The monopoly power of the OPEC countries rests on the fact that the demand for oil is fairly inelastic to price and the supply of oil from non-OPEC sources is also fairly limited in the short term. Leaving aside the political considerations that could be involved, the future development of the world energy situation depends essentially upon the interrelationship of these two factors.

There is no question that conservation efforts in the OECD nations -- the chief consumers of petroleum -- have continued since the oil embargo ended early in 1974. As a result, both the OECD and the oil companies are revising downwards their forecasts of energy demand and imports, often by huge amounts. These forecasts depend crucially on interpretations of whether demand adjustments have been short-run or long-run responses to the rising price. Normally, one would expect that the long-run effect on demand of a higher oil price would be greater than the short-run effect, so that there would be increasing conservation and a lower growth rate of energy demand over the years. However, the oil price rise was also preceded by a direct oil embargo against the United States and the Netherlands and reduced shipments to the other OECD countries and accompanied by explicit exhortation to conservation by the governments concerned. Together, these developments produced a greater than anticipated short-run conservation effect. The long-run elasticity of demand is, therefore, probably less than that expected by the OECD but more than that implied in the first chapter of the UN's World Economic Survey, 1974. Table I shows the possible implications for total energy demand by

TABLE I

ENERGY DEMAND AND IMPORTS: OECD COUNTRIES

Million Tons, Oil Equivalent (m.t.o.e.)

	1972	1980	1985
USA			
Imported Supply	240.6	230.5	78.9
Total Final Consumption	1518.6	1767.5	2020.6
CANADA			
Imported Supply	-30.3	-45.0	-65.7
Total Final Consumption	139.3	187.1	222.5
OECD - EUROPE			
Imported Supply	755.3	737.8	912.1
Total Final Consumption	993.4	1313.1	1655.6
EUROPEAN COMMUNITY			
Imported Supply	605.0	627.6	781.6
Total Final Consumption	814.7	1072.6	1307.4
JAPAN			
Imported Supply	287.7	480.3	590.9
Total Final Consumption	269.4	473.4	603.9
AUSTRALIA			
Imported Supply	-4.1	-22.9	14.8
Total Final Consumption	44.2	68.94	93.0
New Zealand			
Imported Supply	4.1	2.7	2.1
Total Final Consumption	6.7	7.8	9.1

Source: Calculations based on Tables 2D-1 through 2D-21 in Energy Prospects to 1985, (Paris: Organization for Economic Cooperation and Development, 1974) Vol. II, pp. 14-34.

OECD member countries of an oil price of \$7.50, assuming elasticities as computed by the OECD. These estimates probably represent the lower limits on the net energy import demands of this group of countries. The total energy import requirement for these developed countries in 1985 is at least 1,533 m.t.o.e., of which 90 percent will probably be oil.

The current price of oil of approximately \$9.32 tax paid, FOB Gulf (average of equity and buyback oil) is being maintained not only by restriction of output, but also by the threat of further curtailment if the political changes sought by the Arab members of OPEC do not occur sooner or later. Setting aside the political considerations, there are two related questions with respect to oil supply and price prospects. The first is the extent to which petroleum production is likely to increase from old and new sources outside those OPEC countries willing and able to restrict their own output to maintain a monopoly price or for other economic reasons. The second is how much reduction in output the latter are willing and able to sustain in order to maintain a monopoly price. For, ceteris paribus, the greater and more prolonged the restriction of production has to be, the more likely it is that a cartel will disintegrate either by cheating or by tacit or explicit agreement.

Among OPEC members, there are widely varying degrees of willingness and ability to restrict production for economic reasons. At one extreme is the first category of countries that are thinly populated and either already have high per capita incomes, such as Kuwait, and/or limited capacity for domestic investment and imports relative to their foreign-exchange earnings, such as Saudi Arabia. At the other extreme is the

second category, those that can utilize all or most of their receipts from petroleum exports, such as Algeria, Nigeria, Indonesia, and Ecuador. In between is the third category of countries, such as Iran and Venezuela, with relatively large populations and growing capacities for absorbing domestic investment and imports; while able to spend substantial portions of their foreign-exchange earnings for these purposes, they still have large surplus funds. Except for Iran and possibly Iraq, the biggest petroleum reserves and production are in the countries of the first category, notably Saudi Arabia, Kuwait and the United Arab Emirates bordering on the Persian Gulf. These are ipso facto the countries best able to curtail production and, as Arab states, they also have strong reasons for using their economic power for political purposes.

Although the economic reasons vary in each case, enough OPEC members in the first and third categories have hitherto been willing and able either to reduce or to refrain from increasing output to the extent required roughly to equate world supply and demand at the existing monopoly price. Contrary to the reasoning of many people in the OECD nations, who expected the OPEC cartel to collapse within months after the end of the embargo, the curtailment of production has not had to be so deep as to lead to a substantial volume of oil sales significantly below the monopoly price. The question is how long this situation is likely to last. It is possible -- again, as many in the OECD nations have been hoping and urging -- that the OPEC countries will voluntarily cut the price in order to ease the economic difficulties of Western Europe and of many developing countries. But, there is no convincing evidence

of such a disposition on their part; indeed, the possibility of a substantial cut -- as distinct from a marginal reduction -- is specifically denied by virtually all official spokesmen and opinion leaders in the first and third categories of OPEC countries, upon whose willingness it depends. Until now, they have talked much more of increasing the price in order to offset the effects on their import costs of inflation in the rest of the world. Nor can this opposite development be discounted in view of their power to bring it about, at least in the short term.

Crucial to forecasting the future trend of world petroleum price is the time horizon involved. For the short term -- the next 12 to 24 months -- the economic pressures for substantially lower prices are not likely to be strong enough to undermine the cartel. For one thing, as explained later in this Appendix, the recession in the United States and other OECD nations -- although the most severe since World War II -- will probably not be so deep as to reduce demand for petroleum products to the levels required. For another, petroleum supplies from old and new sources outside OPEC are not likely to increase appreciably in the short term. Thus, the probability is greatest that the OPEC price will continue at or near current levels for the next year or two.

However, for the medium term -- the period from mid-1976 or early 1977 to the end of the decade -- the complex of interacting economic factors involved will begin to change at an accelerating rate. On the one hand, the current recession will be over and demand for petroleum would tend to rise somewhat, all other things being equal. On the other hand, capital investment in energy-saving machinery and equipment -- largely induced by continuation of the monopoly price at or near current levels over

the shorter term -- will have an increasing effect in holding down the rate of growth of demand. More important, additional supplies will begin to be forthcoming from new sources -- the North Slope of Alaska, the Gulf of Mexico, the North Sea, East and Southeast Asia, Mexico, and other non-OPEC locations where exploration, drilling of producing wells and the construction of ancillary facilities are already or will soon be under way -- and probably even from old sources in the Gulf of Mexico and the continental United States.^{1/} And, if the recent predictions of the growth of China's petroleum output are realized, it could be an important new supplier to the world market by the end of the decade.^{2/}

As Canada has been doing, the new petroleum-producing nations are likely to conform to the OPEC monopoly price at least for that portion of their output sold in the world market. But, as their production grows, the difficulty of holding the monopoly price will increase correspondingly. Since the newcomers are unlikely to be willing to curtail their production, the OPEC countries will have to continue to bear the

^{1/} Production from old wells in the United States has been declining since the introduction of the two-tier oil-price system, partly as a result of the incentive that the system provides to degrade productive wells to stripper wells. Oil from truly new sources has not been available in very large quantities because exploration has been cut back in the past few years and a shortage of drilling pipe in 1973 and 1974 hampered the opening of new wells. The potential short-term benefits from policies that would encourage and facilitate greater drilling efforts are perhaps indicated by the Bureau of Mines estimate that a 10-percent increase in exploratory drilling would yield a 30-percent growth in domestic crude oil production by 1980. See U.S. Bureau of Mines, Information Circular #8634, 1974, p. 14. In contrast, the National Academy of Sciences has recently (February 1975) questioned the assumptions about domestic reserves on which this estimate is based.

^{2/} Lewis, Christopher, "Outlook Bright for Oil, Coal", Far Eastern Economic Review, October 4, 1974, Focus China '74, pp. 21-22.

burden of maintaining the monopoly price. However, by the end of the decade, the third-category OPEC countries, such as Iran, will be using much more of their oil-export revenues and probably will be unable to assume their share of the necessary restrictions on production. Thus, the first-category OPEC countries will increasingly have the responsibility for such curtailment as is necessary to maintain the monopoly price. Their willingness to do so is by no means assured. On the one hand, depending on the magnitude of the required limitation, they may conclude that current levels of income could be maintained at the monopoly price by cutting production, which would have the further benefit of saving their oil reserves for future use. On the other hand, Saudi Arabia, Kuwait and the United Arab Emirates might soon begin to resent the presumed selfishness of the other producing nations and to feel humiliated at being made "suckers" by them. Another factor operating in favor of cutting the price would be their growing interest in the economic well-being of the OECD countries as their investments in these nations increased. Thus, it is possible that these conflicting pressures could begin to result in significant -- rather than marginal -- declines in the world petroleum price in the later years of the decade.

In the longer term -- the period from 1980 to 1985 -- an additional set of factors will become increasingly operative that could put further downward pressure on the world petroleum price. By then, such research, development and investment as take place during the next six or seven years in the United States and other OECD countries in the production of oil from coal, tar sands and shale will begin to yield economically significant results, and a somewhat larger share of energy needs will probably be met from unconventional sources, such as nuclear, geothermal,

solar, and other forms of power. Also, by the mid-1980s, petroleum production will begin from new non-OPEC sources -- such as the Atlantic continental shelf of North America, the Gulf of Alaska, the Amazon region, China, Siberia, the Indian Ocean, etc. -- where exploration and development will only get under way in the late 1970s. Supplies from such new sources could offset declining production from old sources in the United States, Venezuela and other places, and might even be big enough to increase total world output at a slightly faster rate than the growth in world consumption.

Thus, there is a comparatively high probability that the rate of growth of world demand for petroleum will be sufficiently moderate and the increase in supply large enough to make maintenance of a monopoly price more and more difficult in the course of the late 1970s and the first half of the 1980s. The oil price may, in these circumstances, move closer to \$7.50 (in constant dollars) by the early or mid-1980s.

Aside from geological and technological considerations, the major variable involved will be the energy policy followed by the United States, including conservation measures, development and production incentives and regulations of all kinds, environmental controls, and other factors affecting U.S. consumption, domestic output and imports. Although it is more than a year since the onset of the world petroleum crisis, very little of the range of policy decisions and legislation required has been completed, let alone implemented. From now on, the longer the United States delays in deciding upon and instituting a comprehensive, consistent energy policy, the slower and more uncertain the course of development projected above will be and the lower the probability of an economically significant reduction in the world petroleum price.

The World Petroleum Situation: Macroeconomic and Monetary Effects

One of the more obvious results of the OPEC cartel and the attendant quadrupling of the world oil price has been the creation of an enormous new source of saving in the world economy. As shown in Table II, the production costs for Saudi-Arabian crude oil are of the order of 10 to 20 cents per barrel, with the rest of the FOB Gulf price constituting current saving, most of which is now transferred to the monetary reserves of the Gulf states. As a result, the accumulated monetary reserves of the OPEC countries are estimated to total \$80 billion by the end of 1974. If this sum were to be invested at a nominal rate of 10 percent, the interest would be about equal to gross oil revenues only a few years ago. Even assuming that the world oil price begins to decline in the late 1970s, as explained above, the addition to reserves each year from oil sales, net of production costs, might nevertheless lead to accumulated reserves by 1980 of as much as \$600 billion as shown in Table III.

The size of the problem is well-recognized -- its nature is much less so. In theory, to the extent that part of this money remains unspent, the net increase in savings would have a strong deflationary effect on the world economy. Gross private investment in the OECD countries in 1972 was about \$612 billion, so the 1974 saving increase by the OPEC countries would be of the order of 10 percent of the supply of saving in the industrialized countries in the earlier year. Moreover, it would be about 1.9 percent of the gross domestic product of the OECD

Table II
Estimated Cost of Saudi Arabian
Arabian Light Crude Oil
 (Equity) 36° delivered to Philadelphia
 (\$/barrel)

	<u>January 1, 1973</u>	<u>October 16, 1973</u>	<u>January 1, 1974</u>
Production cost	0.15	0.15	0.15
Government take	n.a.	n.a.	6.96
Company margin	n.a.	n.a.	1.32
Cost FOB Ras Tanura for Equity crude	1.95	3.68	8.43
Tanker charges	1.14	1.82	1.93
Duty or license fee	0.105	(Zero for oil within allocations)	
Total delivered cost	3.195	5.50	10.36

Sources: Energy Prices 1960-1973, Foster Associates, 1974.

Petroleum in the 1970s, U.N. 1971.

Petroleum Economist, September 1974.

See also: Petroleum Intelligence Weekly, February 4, 1974, pp.2, 4: PIW
 Supplement, October 8, 1973, p. 4.

Table III

Estimates and Projections of OPEC Monetary Reserves
(billions of dollars)

	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1980</u>	<u>1985</u>
Oil Revenues	24	100	117	167	254
Export Surplus	11	60	65	67	28
Reserves	26	80	155	600	1200

Source: World Bank informal estimates and projections, reported variously in the Washington Post, Petroleum Economist, World Financial Markets: adjusted for \$7.50 price of oil.

Note: OECD projections are considerably lower (reserves of \$300 billion by 1980) as a result of an assumed oil price of \$9 per barrel and greater substitution of alternative energy sources.

nations. Thus, if the OPEC savings were not to be matched by equivalent expenditures -- either consumption by the Arab and other oil producers or investment stimulated by the availability of funds -- then it clearly would have a considerable deflationary potential.

In contrast, it has been argued^{3/} that the world energy situation would have an inflationary impact in the medium term. It has stimulated and will continue to encourage all kinds of governmental and private actions in consumer countries to reduce -- or slow the growth of -- consumption of petroleum and to increase domestic energy production. As illustrated by Table IV, these efforts necessarily mean investment in less energy-intensive capital equipment, in accelerated replacement of old energy-using machines, and in the development of new technologies and sources of energy supply. The net impact of the investment/savings effects of the oil price rise depends on the relationship between OPEC savings and this induced investment. In any given year, nothing constrains the two to be equal, and in fact the presumption is that induced investment would exceed the total OPEC savings. This would, in a world where excess capacity exists, tend to raise world product, and at a time of high world demand would be inflationary.

In practice, it is convenient to split the analysis into two parts: first, an examination assuming that capital markets work perfectly and discounting monetary complications; and second, a discussion of the ways in which real outcomes might be implemented in terms of existing capital and financial markets. This division usually corresponds roughly to that between long-term and short-term concerns but, in this case because of the magnitude of OPEC savings,

^{3/} Anthony Harris, The Economic Implications of Higher Oil and Commodity Prices: A Medium-Term Assessment (Washington, D.C.: British-North-American Committee of the National Planning Association, forthcoming 1975).

New Energy Policies and their Consequences

(1) Aim of Policy	U.S.			U.K.			'Old' E.E.C.			Japan		
	Imported oil to account for 25% of oil consumption in 1985.	Imported oil to account for about 10% of primary energy in 1980	Imported oil to account for 40/50% of total primary energy. Need to secure supplies.	Imported oil to account for 55/65% of primary energy. Need to secure supplies.								
(2) Total additional capital spending 1974-1985 (in 1973 prices)	\$600 billion	£25/30 billion	\$300/400 billion	Y. 55/70,000 billion								
(3) Prospective additional spending as annual average (1973 prices)	\$60 billion	£3.5/ 4.5 billion	\$45/60 billion	Y. 8/10,000 billion								
(4) Total fixed capital spending, except dwellings, in last 3 years, (annual average)	\$120 billion	£7.5 billion	\$162 billion	Y. 15,000 billion								
(5) GNP Growth annual average 1974-1976	\$50 billion	£0.7 billion	\$50 billion	Y. 12,000 billion								
(6) Gross balance of payments cost of imported oil, 12 months ending September 1973	\$6.6 billion	\$2.0 billion	\$10.4 billion	\$5.4 billion								
(7) Estimated gross balance of payments cost of oil in 1980	\$11 billion	\$0.3 billion	\$28.0 billion	\$12.3 billion								
	in 1985			\$15.6 billion								

Sources: U.S. Energy Prospects -- An Engineering Viewpoint, (Washington, D.C., 1974), National Academy of Engineering; Rybczynski, Tibor M., Capital Requirements for Energy Development in the Main Industrial Countries, Working Paper prepared for the British-North-American Committee, National Planning Association, June 1974; Survey of Current Business, September 1973 and 1974; OECD Main Economic Indicators, September 1974; U.N. Commodity Trade Statistics, 1973; U.N. Statistical Yearbook, 1973; The Bank of England Quarterly Bulletin, June 1974; Economic Planning Agency, Tokyo, 1974.

Note: Line 7 has been calculated on the basis of Table I.

the latter will persist for most of the decade. Nevertheless, without implying that the financial aspect is unimportant for the real outcome, discussion of it will be deferred.

The largest part of OPEC savings will be accumulated by the first-category countries identified in the preceding section. For, their own capacity to absorb imports and domestic investment is and will continue to be limited.^{4/} So, too, will be the amounts that they are willing to invest in or give as aid to the developing nations. Hence, over time, the bulk of their accumulated surplus -- will sooner or later have to be invested in one form or another in North America, Western Europe and Japan.

It does not matter whether this financial transfer from the Arab states to the OECD nations takes place through purchases of fixed-interest governmental and private securities or through equity investment or in real estate or other forms: the question is whether real investment demand will be forthcoming. Part of the answer is that the high oil price itself engenders industrial investment and the expansion of non-OPEC energy supplies; if plans outlined in Table IV are carried out to their fullest extent, they would be more than capable of mopping up the whole of the Arab surplus.

However, the full \$600 billion estimated for the U.S. Project Independence seems more and more unlikely to go forward. The annual cost would be a full 4 percent of projected 1978 GNP, and would be 7 1/2 times the peak cost (in 1973 dollars) of \$8.1 billion for the U.S.

^{4/} Footnote added February 1975: In the light of the experience of the last half of 1974, estimates of the absorptive capacity of the OPEC countries appear to have been too low. Chenery projects approximate current account balance by 1980, with financial accumulation of about \$300 billion in 1974 prices. Hollis B. Chenery, "Restructuring the World Economy", Foreign Affairs, Vol. 53, No. 2, January 1975, pp. 242-263.

space program in 1966. The likely levels of investment in the United States will be discussed below in the section on the outlook for the United States. Here, it needs only to be noted that several private forecasters project a total increase in GPD, including energy investment, of the order of 4.3 percent a year in real terms between now and 1980, which is -- if anything -- a little below the average growth rate of the 1960s. There is considerable disagreement as to what will in fact be the constraining limit on investment in the United States over the next ten years. A widely publicized view is that there will be a capital shortage. One of the more authoritative versions of this forecast,^{5/} appears to be based on rather higher real investment than in the past and on a low share of profits in the national income, which would force companies to turn to the capital markets rather than to retained earnings for their investment funds. If this forecast were to be correct, the rate of return on borrowed funds would be high, the surplus OPEC countries would have incentives to lend to or take equity in U.S. companies and the real transfer could work itself out smoothly.

Nevertheless, it seems unlikely that the share of profits in the U.S. national income will remain as low as it was in the early 1970s. Recently, high raw material prices and a high rate of inflation have tended to alter the distribution of income towards profits, which makes it probable that their share will rise towards the levels reached in the 1960s. In addition, it seems very likely that the tax laws will be changed so as to permit greater allowance for depreciation; for, if they are not so

^{5/} Dmitri Balatsos, Conference Board Record, August 1974.

changed, common prudence will force companies to set up special reserves to cover the difference between depreciation allowances and the replacement cost of capital equipment. In either case, the high continuing rate of inflation will have the effect of raising the sum of depreciation allowances and undistributed profits, which are the amounts that the U.S. private sector will have available from its own resources for gross capital expenditure.

Moreover, capital investment both in the United States and other OECD countries will tend to be concentrated in the years 1976-1979 for reasons explained in subsequent sections of this Appendix. In brief, the remaining years of the decade should see some catching-up in capacity expansion, while the 1980s will witness slower labor-force growth in several key nations. But, the period 1975-1979 covers the years of fastest accumulation of the OPEC countries surplus -- i.e., before their domestic absorptive capacity is likely to rise substantially -- thereby coinciding with the years when a high demand for OPEC funds should exist in the OECD nations.

For the immediate purpose -- i.e., to establish whether the OPEC savings pool will tend to increase or decrease world output -- this is really all that needs to be said. Continuing to leave aside the financial question, the likelihood is that the pool of OPEC savings will increase rather than decrease real world expenditures and hence lessen the probability of a world depression. This is because in advanced countries, the higher cost of imports reduces real incomes and, hence, lowers savings: that is, real consumption is reduced by slightly less than the resources drawn off

by OPEC. These resources are, however, fully spent on investment, thus generating a slight excess of ex ante investment over saving, and leading to higher levels of output. This explanation points to one source of confusion in the current discussion of the effects of the oil price rise. If the transfer problem is successfully solved, then real incomes in oil-consuming countries will be lower than they otherwise would have been, but total output, and hence employment, will be higher. Successful transfer, therefore, will help to avoid depression; and those commentators who worry that lower consumption resulting from the higher oil price will lead to depression are simply missing the point.^{6/}

In contrast, if the transfer problem were not to be solved, then a totally different situation would result: it would be like that of Germany between the wars or that which Western Europe would have faced after World War II had there been no Marshall Plan. As in interwar Germany, if the above projected real transfers do not take place, the oil-consuming nations would face depression and/or even more severe inflation, or continually depreciating currencies vis-à-vis the OPEC countries. This danger is, however, unlikely to materialize for the reasons given above.

Recent discussions of the world petroleum problem have focused much more on the special financial aspect labelled "recycling" than on the basically more important question of real transfers discussed above.

The recycling problem arises from the fact that the most pressing need for funds is in those countries, such as Italy and India, where the investment risks -- economic and political -- are highest. For their part, the surplus OPEC nations will naturally tend to invest where risks can be minimized. The financial problem, then, is how to avoid too much damage

^{6/} This fear was expressed most influentially by the editorial writers of The Economist during the spring and summer of 1974.

to those countries least able to attract the necessary funds and, therefore, most likely to suffer cuts in real income without any offsetting increase in the output of capital goods. There is no reason to expect the commercial banks and other private financial institutions to go on lending indefinitely to such nations, despite the private capital market's rather good record in past years in providing Italy, France and the United Kingdom with balance-of-payments financing. This problem has already led to the establishment of the IMF's "oil facility" and to direct and indirect loans from the surplus OPEC nations to the United Kingdom, Japan and some of the needy developing nations to help finance their balance-of-payments deficits. But, in the absence of specific actions by the OECD governments and international organizations, the surplus OPEC countries are unlikely to provide more than a relatively modest portion of the financing required to resolve the payments difficulties of the deficit nations in the next two or three years. This prospective recycling problem has led to a variety of proposals under which the OECD nations directly or indirectly through the IMF, the World Bank or other international organizations would in effect guarantee OPEC loans to Italy, Britain and the developing countries, including guaranteed real interest rates and insurance against default risk.

There are considerations on both sides of the question of whether and to what extent the United States, Germany, and the other better-off OECD nations should act as financial intermediaries for the surplus

OPEC countries in order to meet the borrowing needs of Italy, the United Kingdom and the developing nations. On the one hand, the size of the surplus funds of the OPEC countries will probably grow so large in the next two or three years that their eagerness to invest them in the United States, Germany and other better-off OECD nations can be used as a lever to induce them to provide larger, unguaranteed loans to the needy OECD and developing countries than they otherwise would be willing to do. Implementation of this tactic by the United States would probably require supervision of the inflow of foreign investment and of the repatriation of interest and dividends thereon. On the other hand, as explained in Chapter II, adverse political consequences both within OECD nations and in their relationships with the United States would very probably result if the balance-of-payments financing available to those in need were to be too little or too late. On balance, then, while market incentives and official OECD policies should be made as conducive as possible to channeling surplus OPEC funds to the deficit nations without explicit or implicit guarantees, it must be recognized that this flow is not likely to be nearly sufficient to meet their needs and that some form of guarantee would be required to increase it substantially.

Will There Be a World Depression?

For the first time since the years immediately after World War II, the possibility of a world depression is seriously being put forward. The term depression is not really well defined even for a country and is

less so for the whole world, but the general idea conveyed is, at least, of very high and sustained unemployment in the major OECD nations leading to an actual decline in the world output of goods and services. Those who warn against the likelihood of such a depression disagree as to whether it would be caused mainly by disruptions associated with the world oil crisis or by underlying problems in the world economy associated with the recent synchronizing of business cycles in the OECD nations, or by both.

Since the 1970-71 recession, the economies of the OECD countries and hence of the rest of the world have been moving on a synchronous cycle -- the recessions coincided fairly well worldwide, and then the subsequent boom contributed strongly to the shortages of many materials in 1973 and early 1974. Had the world oil crisis not occurred, it is still probable that a fairly synchronous downturn in many OECD countries would have taken place in late 1974 or early 1975 as the capacity shortages began to tell on real incomes, thus cutting the rate of growth of consumption. In addition, several of these countries were having trouble balancing their external accounts even before the OPEC price rise as a direct result of the overheating of domestic demand, as explained below in the sections on the major OECD nations.

Of course, the oil crisis has exacerbated the balance-of-payments problems in these countries, and has contributed an extra-strong push to domestic prices. But, in surprisingly few OECD nations did it actually have a concurrent impact on domestic output. The only major countries badly affected were Japan and the United States, which experienced actual declines in output in part as a direct or indirect consequence of the

energy conservation measures necessary at the time of the embargo. Except for Britain, where the coal miners' strike was the major cause of the loss of output, the other OECD countries generally experienced a slowdown in growth from effects on the demand side arising from the implicit "tax" imposed by the OPEC nations. While the inflationary effect of the oil crisis is undeniable, the slowdown caused by the oil shortage and price rise was timely in certain countries from the point of view of aggregate management. Some nations, notably Germany and Japan, have been experiencing an export boom during 1974 comprised mainly of capital goods, which were in short supply in recent years and for which world demand still continues to be high.

Despite the potentially optimistic outlook for the world capital-goods industries, there is nevertheless reason for concern about a world recession. In the current slowdown, a notable feature in many OECD countries is how much the fall in output and employment is localized in two sectors -- housing and automobiles. The housing sector is hurt by inflation, which raises both the cost of homebuilding and the nominal interest burden of financing; frequently, in fact, usury ceilings or other institutional constraints prevent money from flowing into the mortgage market at the going rate. The auto industry is hurt partly by the rise in oil prices but much more seriously by the decline in real consumer incomes. In the short term, the health of the world economy depends on real personal incomes -- if they are allowed to continue to decline in the major OECD countries, the slackening in demand is liable to spread to other sectors within them, including capital goods, and then to the developing nations.

The danger of a world depression, therefore, lies in the possibility that the governments of the key OECD countries may see the main problem as inflation rather than the decline in real incomes, and hence may do exactly the wrong thing -- reduce rather than stimulate aggregate demand. In this view, while the inflation of 1972-73 may have had excess-demand or demand-pull components, that which exists now and prospectively is almost exclusively a cost-push inflation, compounded by administered pricing and certain exceptional factors. In any period of inflation, the receivers of income -- wage and salary earners and owners of capital -- seek to maintain their real incomes by trying to keep their money incomes in step with price rises. The fact that "one man's price is another man's income," naturally tends to intensify and prolong a rise in prices, whatever its initial cause. When, however, real incomes are allowed to get seriously out of line -- for example, because of a large unanticipated price rise -- the inflationary push generated in this way is substantial. In the case of the oil price rise, it is not clear that even correct anticipation of the price rise on the part of all economic individuals would have avoided an inflationary push, since it represents a reduction in general purchasing power in the oil-importing countries. The inflationary process of competitive income claims is a way of allocating that reduction in real income among the different segments of the population -- in particular, to that segment which has least power to raise its own income claims. In the absence of government intervention, this inflationary process might require a period of three to five years to work itself out. Whether the rate of inflation beyond that period would be higher than before would depend on the extent to which expectations of higher inflation were incorporated into wage bargains and other forward contracts.

Probably few, if any, OECD governments believe that they can get down again to the inflation rates of the 1950s or 1960s through aggregate demand management alone. Germany's severe deflationary policy in 1974 is possibly the only instance in which such an approach has had the intended short-term effect on the rate of inflation. Most other OECD countries have been following milder deflationary policies, with less effect on inflationary pressures. Whether the world economy will sink into recession or depression depends essentially on how deeply and for how long deflationary policies will be pressed in the OECD nations. Presumably, the limit will be set by the behavior of unemployment which is now rising in all of them. If, as many commentators fear, the major OECD countries simultaneously maintain restrictive monetary and/or fiscal policies (more likely restrictive fiscal than monetary ones in the current climate) in the face of rising rates of unemployment, then the probability of a world depression becomes correspondingly higher. However, the likelihood is greater that, because this danger has been so widely publicized and feared in the OECD nations, their governments have been made aware of the adverse positive feedback effects of coincident restrictive policies and will seek to avoid them.

The Medium-Term Economic Outlook

The world economic outlook for the remainder of the 1970s depends much more upon the comparatively small populations of the OECD nations than it does on the vast populations of the developing countries. For, the former's productivity is so high that the OECD nations, including

the United States, produce over 80 percent of the noncommunist world's measured output. Thus, although the developing countries will be experiencing large increases in their labor forces over the medium term, a far stronger influence will be the declining growth rate of the labor forces in several of the major OECD nations.

The most marked change will be in Japan, where expected retirements exceed expected additions to the labor force over the next ten years by a significant margin. Much less pronounced, but in the same direction, are prospective changes in the United States which will be witnessing first a gradual and then a rather steep decline in additions to the labor force between now and 1985 as a result of the end of a period of high labor-force growth after the baby boom of the 1950s. Britain, too, expects a slight decline in labor-force growth, though not by much because the previous decline in participation will probably reverse itself. Italy is in a position similar to that of the United Kingdom, with a tapering off of population of labor-force age but also with the likelihood of some increase in labor-force participation.

From a rather crude point of view, this decline in labor-force growth in some OECD nations is disadvantageous over the long term for the developing countries. The long-run growth of an advanced economy is slowed when the growth of the labor force slows, unless some action is taken -- for instance a higher rate of investment -- to increase productivity, or output per worker. The normal expectation is that an advanced country, faced with the prospect of declining real growth, would undertake policy measures to increase investment, since it normally implies a lower standard of living for inhabitants of the country. In other words, the desire of OECD govern-

ments to maintain the growth rate of their economies also helps to provide continually growing export markets for the products of underdeveloped countries.

When the expected decline in GNP growth is accompanied by slowing for demographic reasons in the labor-force growth, there is rather little incentive for the government to take countervailing measures. Per capita GNP, the relevant measure of welfare, keeps on growing at roughly the same rate. However, the market for imports from less-developed countries depends on the total size of GNP, and this will tend to grow more slowly. Less-developed countries with high rates of population growth are likely to be hurt by prospective declines in population growth in the developed countries.

There are, of course, exceptions to these demographic changes. Several OECD nations (e.g. Canada, Australia, New Zealand) expect a continued high growth rate of the labor force. However, these are precisely the OECD nations that tend to compete with developing countries as sources of raw material supply rather than constituting important markets for them. Therefore, by the 1980s, contrary demographic changes in the OECD nations and in the developing countries will magnify the difficulties that the latter are already experiencing from the rise in oil prices and their recurrent food shortages.

Assuming that a serious world depression is avoided, capital investment will be strong for the remainder of the 1970s despite the slowdown in real growth rates. There is already a backlog of undercapacity, which accounts for the current high level of capital-goods orders; for example, the steel industry worldwide will be constrained by capacity rather than by demand as soon as recovery from the present recession is under way. Over the medium term, investment in pollution control equipment and accelerated obsolescence of existing energy-using and highly polluting

machines will be an important part of the capital spending of the OECD nations -- as much as 10 percent of U.S. capital spending, for example, is projected to be for meeting new pollution control regulations alone and without counting accelerated obsolescence. This trend -- while it will further slow down measured GNP growth by shifting output towards the "unmeasured product" of environmental quality -- will not affect the exports of developing countries proportionately because the investment needs will tend to keep industrial activity in the capital-goods industries at a relatively high level.^{7/}

The problems associated with the transfer of real purchasing power from the OECD nations and the non-oil-producing developing countries to the OPEC nations and the associated recycling and financing problems have been discussed above with moderately optimistic conclusions. An additional aspect of the world petroleum situation that has worried some commentators is the resulting large OECD indebtedness to the OPEC countries, which their massive reserves will represent, and the presumed difficulty of servicing a debt of this magnitude. However, if the real resource transfer is accomplished at all, it will result -- as explained above -- in a flow of investment funds directly or indirectly to the OECD nations from the OPEC countries. To the extent that these funds are invested productively, they will yield the increase in output and income necessary to service the debt. In fact, to the degree that their investment is direct rather than indirect, the OPEC countries will in a real sense be servicing the debts they own themselves.

^{7/} For the United States, these forces are described more fully in The U.S. Economy: 1973 to 1983, (Washington, D.C: National Planning Association, 1974), 1973 National Economic Projections Series (NEPS).

Thus, there is little reason in the current situation to be pessimistic about the medium-term outlook for the OECD nations. True some countries -- the United Kingdom, Italy, perhaps France, Denmark and Ireland -- that are among the worst affected by the oil price rise, can expect to have substantial payments difficulties. To the extent that inflation abates during the next year or so, the rise in import prices resulting from a currency devaluation would become more tolerable and deficit countries might then allow their exchange rates to depreciate to help balance their external accounts. The United Kingdom will undoubtedly have to bear an irreducible burden of debt for oil payments well into the 1980s. But, except for Italy, the economic problems faced by most other OECD nations will not be as difficult. Even so, as pointed out in the country section below, Japan can probably no longer rely on export-led growth to the extent it has in the past, and it will probably have to accept a somewhat lower rate of growth of real living standards in the future (although these standards, of course, will still be rising).

As explained earlier in this Appendix, it is technically feasible for the OECD countries to avoid allowing the problem of recycling oil money to disrupt the international economic system. Technical feasibility, however, does not always guarantee success -- also required are appropriate economic policies on the part of the governments concerned. National economic policy makers in the major OECD nations, especially the United States, must be willing to recognize the inadequacy of traditional fiscal and monetary tools for demand management in the kind of international economic system that exists today. They must be willing to expand aggregate demand in order to offset the flow of purchasing power to the OPEC countries even though they seem to be faced with persisting inflation. They will have to keep up their nerve while accumulating possibly unprecedentedly

large volumes of external debt if the surplus OPEC countries insist on holding money-market securities rather than putting their funds into direct investments. These requirements temper the rather optimistic outlook projected on the basis of economic trends and technical feasibility.

In the sections that follow, brief sketches are presented of the short-term and medium-term outlook for the six largest OECD nations, as it appeared in the fall of 1974.^{8/} They are intended to elucidate the expectations which underlay the analysis in the foregoing section, and should not be regarded as currently valid projections. A short-term forecast for the United States, prepared by Wilfred Lewis, Jr. and the writer in February 1975 will be available from the National Planning Association at the beginning of March.

United States

The United States is now in the middle of its deepest and longest postwar recession, although that fact has only recently been acknowledged by official spokesmen. Price inflation, which has accelerated since 1968, has been astronomical by U.S. standards this year. In part, it is directly attributable to the oil embargo and to the subsequent higher price of oil, which tends to increase wage demands by reducing

^{8/} The tables of indicators for countries other than the United States were prepared on the basis of the OECD's Main Economic Indicators, individual OECD country reports, and various bank reports and other sources, and were compared with Chase Econometric's International Econometric Forecasts (July 1974). No attempt was made to model these economies as the major purpose of these sketches is to provide a basis for qualitative judgments regarding trends in trade and payments. In contrast, the analysis of the United States does stem from a formal econometric model developed by Chase Econometrics and used by NPA in preparing its long-term projections of the U.S. economy. The tables for each country differ in the series presented owing to the diversity of sources of projections consulted. However, in each table, at least one of each of the following is included: a measure of output, a measure of price and wage inflation, a measure of labor market conditions, and the balance of trade. The series presented are mostly not comparable across countries, and should be regarded as indicating the pattern of expected future developments in them rather than their comparative levels of welfare.

the real incomes of workers. This effect is fairly independent of the level of activity in the economy -- the more so this year because the recession has so far been concentrated in relatively few industries. Many other industries have had long order books and have managed to increase profit margins this year, which both reduces the incentive to lay off workers and increases the apparent rise of the corporate share of income. The fact that much of these profits is nothing more than the illusory effect of insufficient depreciation allowances does not usually enter into the calculations of workers or of management at the level at which decisions about layoffs are made.

Shortages have persisted in several industries over the summer, but this has not managed to stave off recession. At least part of the reason may be that firms -- looking at their sales figures, as they do at their profits figures, in money terms rather than adjusting them for inflation -- cannot believe that a recession is in progress, and hence place orders for intermediate and capital goods on the basis of inflated sales forecasts. At least some of the tightness in the steel market, for instance, may have been as misleading as the relatively low unemployment rate. It is this kind of behavior which, in its turn, has apparently misled those officially responsible for U.S. macroeconomic policy.

Concurrent with the oil price rise, another redistribution of income was in progress -- from the manufacturing and service sectors towards the farm sector. This had similar effects on wage demands by raising the cost of living of workers. However, the purchasing power shifted by the rise in world agricultural prices accrued in the main to U.S. citizens and corporations so that the impact on aggregate demand in the United States was minimal.

Government response has so far been directed almost entirely to controlling inflation in prices rather than in incomes. Thus, although price controls were lifted in April 1974, monetary policy was kept very tight for the next five months and at least the announced fiscal policy has been contractionary. As a result, the housing market especially has suffered, leading to rises in rents that add more inflationary pressure to wages. In recent weeks there have been some signs that monetary policy is being eased, but this has not yet resulted in a rise of the money stock.

Tight monetary policy has an especially perverse effect at this stage. As noted above, capacity in several industries is barely adequate for current levels of demand; any upswing in the economy would, therefore, generate immediate excess demand inflation in these sectors. However, tight monetary policy holds back investment both by raising interest rates on borrowed money and by encouraging the shift of private savings from the stock market to the money market. For firms with debt/equity ratios already much higher than is usual in the United States, the latter shift is very important and is additional to the shortage of equity finance because of a general lack of confidence on the part of investors. In this situation, the marginal cost of investment finance becomes very high and reduces real investment.

Concurrently, demand has been falling for several types of consumer goods, of which the most heavily publicized has been automobiles. A large part of the reason is the fall in real incomes, coming at the same time that auto prices have to rise to cover increased costs, including that for new antipollution equipment. The reduction in volume of sales does two things: it increases unit costs because fixed costs have to be spread over a smaller output, and it causes the auto companies to reduce their capacity so as to lower fixed costs. The result is an

increase in the price of automobiles now and a likely shortage of capacity whenever demand should rise again.

It is possible to explain along these lines much of what has happened this year -- inflation, relatively high employment, high measured profits, falling investment plans, low consumer demand -- as a result of the oil and food price rises and of an inappropriate government response on the macroeconomic level. However, certain specific factors should not be overlooked.

As a result of the general concern with inflation, one of the early responses to the oil price rise was the introduction of the two-tier oil price system. It was intended to hold down the domestic price of oil until the OPEC cartel broke up -- a development initially thought to be imminent. In the meantime, the system was to give the maximum incentive for oil exploration, opening of new wells, and secondary recovery. In fact, it appears to have accelerated the downgrading of producing wells to stripper wells, while new drilling was hampered by shortages of drilling equipment. As a result, the system held down domestic supply rather than increasing it, while the artificially low price of oil to consumers discouraged conservation and increased oil imports.

Because of the peculiar character of the current downturn, inventory investment has been high and a significant amount of inventory decumulation can be expected to occur. This process has already started, sparked by the August fall in industrial production, and has resulted in a sharp easing of capacity shortages and almost zero inflation in the wholesale price index in September. As might be inferred from the gathering consensus of Administration economists, the recession from now

on will have a more usual form, with inventory decumulation, few if any capacity shortages, and rising unemployment, which mounted to 6 percent in October.

Stated government strategy still involves relatively tight monetary and fiscal policies to deal with inflation. There is little chance that they will produce the desired results partly because the fiscal component -- as expressed in the President's message to Congress after the economic summit -- is tiny and runs in the wrong direction, adding about \$500 million to aggregate demand^{9/}; and partly because wage inflation, at least, is caused by the efforts of wage earners to maintain their real incomes. The high unemployment -- in the range of 6 to 7 percent in 1975 -- will have some effect on wage inflation, but the combination of the attempt to catch up to this year's cost of living rises and the expectation of future inflation will necessarily be built into wage agreements. A spectacular decline in inflation is, therefore, unlikely to occur next year.

The economic upturn is expected around the middle of 1975, following the end of inventory decumulation. As it starts, inflationary pressure will tend to increase once more as rising demand presses against those bottlenecks that have not been eliminated in 1974 and the new ones created by the restriction of investment finance and the reduction in capacity in some industries resulting from declining sales. This is most clearly visible in the behavior of the deflator for plant and equipment in Table V.

The adverse impact of the oil price rise on the U.S. balance of trade is partly offset by the high prices for U.S. food exports. Although

^{9/} Chase Econometric Associates, October 23, 1974.

1974's first-quarter surplus was large, a deficit appeared in the second quarter and an even larger one in the third. The merchandise deficit is expected to increase in 1975, partly as a result of lowered international food prices and partly because domestic capacity shortages in the second half of the year will induce rises in imports. The deficit will continue to be financed largely by capital inflows, particularly from OPEC countries.

The medium-term outlook for the United States envisages a declining rate of inflation and a lower level of unemployment. However, expectations of inflation are such a large cause of actual inflation that the GNP deflator is not likely to increase at less than 5 percent for the rest of the decade unless wage and price controls are instituted, or unless some imaginative innovations, like the French excess value added tax explained below, are introduced to bring about a redistribution of real income away from profits.

Domestic unemployment will fall during the remainder of the decade not only because of the recovery from the current recession but also because of an underlying change in the structure of labor markets. Structural unemployment has been high for the past few years owing to the entry of unusually large numbers of young people and women into labor markets. This has raised unemployment, quite apart from any cyclical effects, because these people tend to change jobs more frequently and to spend more time looking for jobs. This type of unemployment is not desired by those involved but reflects the special characteristics of this segment of the labor market. For demographic reasons and because female labor-force participation will stabilize, structural unemployment can be expected to be almost a full percentage point lower by 1980 than it is

today. Thus, the degree of tightness of the labor market, which now leads to 5.6 percent unemployment, should be translated into something more like 4.6 percent in 1980.

In addition, starting at the beginning of 1976, there should be a capital-goods boom. It will be set off by inventory building and the capacity shortages expected after next year's recovery; and it will be carried forward by capacity expansion, which will by then have been delayed for three years, and by spending on energy supply, energy conservation and pollution control. This capital-goods boom figures in almost every forecast, and leads to fears of a shortage of savings sufficient to finance it. Much of this fear is generated by the tendency to look at the sheer volume of funds to be raised; but, several considerations suggest that no capital shortage will develop.

For one thing, it is likely that tax laws will be liberalized by 1976 to permit depreciation allowances based to some extent on replacement costs. In an economy with inflation, this would in itself leave funds for investment in the hands of the corporate sector. Second, the capital-shortage forecasts generally assume that the share of profits in national income will remain at the depressed levels of 1971-72 -- an assumption that, as explained above, will probably not accord with the facts. It is more likely that retained earnings will be higher than assumed. Finally, capital inflows from OPEC countries will be available at fairly reasonable terms because the United States is the safest place in which they can put their money.

During the remainder of the decade, the prospects of a rapid reduction in oil imports through substitution of domestic resources are

not good either for technical or for economic reasons. A tight monetary policy is inconsistent with an attempt to increase domestic energy investment; in addition most of the available new energy sources cannot be developed quickly. It takes three or four years to develop a coal mine, eight years to build a nuclear power plant, and an uncertain time to extract oil from shale or to make synthetic crude from coal. Furthermore, additional investment will be needed to make use of these new power supplies -- processes have to be converted to using coal or electricity instead of oil.

Conservation is equally difficult. As pointed out in this Appendix, most of the easy things have been done already, and further conservation is delayed by the artificially low domestic price of oil. The problem is, however, not so important for the United States as for other countries. In view of the fact that the United States is likely to attract the largest share of OPEC investment, the incentive to conserve oil is not primarily for its direct impact on the U.S. balance of payments but for what a reduction in U.S. oil imports might do to put downward pressure on the OPEC price and thus benefit the payments problems of other OECD nations and developing countries.

TABLE V
UNITED STATES
GROSS NATIONAL PRODUCT

	1974				1975				1976				1977
	QT 1	QT 2	QT 3	QT 4	QT 1	QT 2	QT 3	QT 4	QT 1	QT 2	QT 3	QT 4	QT 1
GNP	1358.80	1383.80	1411.60	1439.22	1475.19	1520.23	1565.75	1618.05	1671.52	1729.33	1790.37	1848.92	1907.51
GNP, \$58	830.50	827.10	821.10	812.68	813.15	821.77	831.42	844.09	856.78	870.84	886.30	899.07	913.25
Consumption	840.64	869.14	899.97	920.65	945.54	971.38	997.70	1027.59	1061.29	1096.70	1132.81	1170.03	1206.27
Gross private investment	210.66	211.73	204.58	203.43	207.39	210.79	228.81	240.88	251.09	263.39	278.29	291.12	301.86
Nonresidential investment	145.26	149.50	152.53	157.56	162.97	163.35	173.29	180.67	187.46	193.09	202.00	210.53	218.10
Plant & equipment investment	93.96	97.30	101.13	105.38	109.75	113.69	117.16	122.51	127.02	131.44	137.34	143.66	148.26
Plant & equipment investment \$1958	69.70	69.90	69.60	70.60	71.79	72.94	74.18	75.90	77.07	78.26	80.30	82.29	83.70
Housing investment	48.50	48.73	46.25	40.92	40.59	46.19	51.43	54.65	55.25	55.93	57.32	59.67	62.72
Inventory investment	16.90	13.50	5.80	4.95	3.83	4.25	4.10	5.56	8.38	13.57	18.97	20.99	21.04
Net exports	11.31	-1.40	-4.18	-6.31	-7.00	-7.60	-8.13	-8.98	-8.22	-6.70	-5.44	-7.68	-4.69
Exports	131.20	138.50	143.90	143.78	147.95	155.01	158.02	162.78	167.29	174.13	177.55	180.31	183.80
Imports	119.89	139.90	148.08	150.09	154.95	162.60	166.15	171.77	175.51	180.82	182.99	187.99	188.49
Government purchases	296.30	304.40	311.30	321.40	329.30	337.70	347.40	358.60	367.30	376.00	384.70	395.40	404.10
Defense purchases	75.80	76.60	78.80	80.80	82.00	83.20	84.70	87.20	88.70	90.20	91.70	94.20	95.70

PRICES AND WAGES (% change, annual rates)

	1974				1975				1976				1977
	QT 1	QT 2	QT 3	QT 4	QT 1	QT 2	QT 3	QT 4	QT 1	QT 2	QT 3	QT 4	QT 1
Consumer Price Index	11.23	11.70	12.73	13.51	10.21	9.14	7.43	6.47	7.24	7.36	6.92	7.46	6.15
GNP Deflator	11.86	9.24	10.83	12.05	9.75	7.89	7.20	7.16	7.10	7.15	6.90	7.21	6.27
Plant & Equip. Deflator	7.56	13.06	17.53	10.93	9.65	7.36	5.29	8.81	8.41	7.65	7.31	8.29	5.84
Wholesale Price Index	25.60	33.48	28.04	14.41	12.36	10.49	10.02	8.57	7.18	6.83	5.84	6.84	6.53
Wages, Manuf.	3.84	10.45	13.61	8.61	9.80	11.76	11.12	10.66	10.78	11.76	10.94	10.47	11.04

TABLE V (continued)

NATIONAL INCOME

	1974				1975				1976				1977
	QT 1	QT 2	QT 3	QT 4	QT 1	QT 2	QT 3	QT 4	QT 1	QT 2	QT 3	QT 4	QT 1
National income	1122.01	1131.17	1153.39	1177.08	1203.08	1239.05	1280.65	1327.17	1371.96	1421.95	1473.64	1526.46	1575.39
Employee compensation	832.00	849.37	871.19	891.55	914.70	944.49	978.61	1013.19	1042.13	1074.81	1108.24	1144.14	1175.55
Wages & salaries	730.81	745.67	764.49	782.25	802.30	828.99	857.21	888.39	913.93	943.21	972.94	1005.14	1033.05
Proprietors' income	98.40	89.80	90.70	95.37	98.23	98.82	100.34	102.36	104.31	106.89	109.67	112.14	114.83
Profits before tax	138.70	143.50	137.20	120.62	113.79	116.07	118.78	125.90	134.52	148.15	157.83	172.47	184.63
Profits tax liability	53.70	57.90	55.40	49.11	50.44	52.40	53.55	56.45	56.96	62.46	66.39	72.29	76.19
Profits after tax	85.00	85.60	81.80	71.51	63.35	63.67	65.24	69.46	77.56	85.70	91.45	100.18	108.44
Dividends	31.60	32.50	33.20	33.60	33.46	33.48	33.69	34.12	34.72	35.45	36.31	37.27	38.36
Inventory valuation adj.	31.00	-37.90	-35.10	-23.34	-18.86	-18.50	-17.47	-18.28	-16.50	-18.84	-16.54	-20.38	-21.12
Net interest	57.50	60.10	62.80	66.09	68.22	70.97	72.99	76.40	79.70	82.93	86.23	89.69	92.91

Germany

The dominant factor in the recent course of the German economy has been the divergence between the exporting industries and those producing for domestic consumption. While the domestic producers have been hard hit by the rise in oil prices and the concomitant reduction in real disposable income and production, the exporters -- heavily concentrated in the high-technology capital-goods industries-- have been doing extremely well.

Thus, there was little change in real GNP in the first two quarters of 1974 while unemployment was rising substantially and capacity utilization was falling. Consumer spending declined substantially, partly as a result of the downturn in real income and partly (insofar as durables and homebuilding were concerned) because of the tight monetary policy. Production for domestic consumption actually fell in those two quarters but the slack was taken up by a burst of exports, generating record trade surpluses despite the increased cost of oil imports.

This dichotomy goes a long way to explain the low rate of inflation experienced in Germany. While other West European countries have had double-digit inflation, the low level of activity in many German industries and the low rates of capacity utilization have restricted the domestic pressures that otherwise would have reinforced the exogenous price push from oil imports.

The outlook for the German economy depends to a large extent on events abroad. Domestic investment demand is not likely to be strong -- there is spare capacity and surveys of spending plans suggest a low rate of

Investment over the next year. There is some evidence -- in the form of low rents and a large stock of unsold houses -- of recent overbuilding by the housing industry. Expansion will have to come from a continuation of export-led growth, from a revival of consumer demand, or from a more expansionary fiscal policy.

Consumer spending will probably make only a modest contribution to expansion. It is presently constrained by low real income and such monetary relaxation as the German government is likely to permit would probably be too small to help the demand for consumer durables by very much. Expansionary fiscal policy would certainly be appropriate in view of the level of unemployment, but it is also likely to be modest so long as the Germans continue to exhort their neighbors to deflate in order to take the pressure off the mark exchange rate. Thus, the main prospect for German expansion is export-led growth, which depends on the state of world demand for capital goods. The forecasts presented in this Appendix lead to the assumption of a continuing high world demand for capital-goods over the medium term, and hence to the likelihood of a healthy German economy during the remainder of the 1970s.

Table VI

GERMANY

	1972	1973	1973 Q4	1974				1975	1976
				1	2	3	4		
<u>Output</u>									
Gross National Product, DM billion at market prices	829.8	926.2	952.8	957.6	984.2	1005.0	1022.9	1071.3	1156.3
GNP, DM billion 1962 prices	557.3	586.6	588.9	587.5	588.3	589.4	591.3	599.9	614.1
<u>Prices</u>									
Gross National Product Deflator 1962=100	148.9	157.9	161.8	163.0	167.3	170.5	173.0	178.6	188.3
Consumer Price Index 1963=100	132.3	141.4	144.9	168.3	150.7	153.2	155.4	160.7	169.3
<u>Employment</u>									
Unemployed									
Vacancies (Ratio)	.45	.50	.79	1.11	1.79	1.80	1.69	1.32	.98
<u>Trade</u>									
Trade Balance, FOB-CIF \$billion current	8.07	13.10	13.03	18.91	23.05	25.66	27.81	31.55	35.16

Japan

Japan is one of the OECD countries hardest hit first by the 1972-73 commodity inflation and then by the oil crisis. It imports virtually all of its fossil fuels (Table VII) and primary minerals. There is reason to expect that Japan's long-term competitive position has been hurt by the oil price rise. For the first time, this year's recession has not led to a surplus on current account despite the fact that Japan is experiencing a remarkable export boom.

Oil supplies 75 percent of Japan's total energy requirements, and 63 percent of its industrial needs. As a result, the 10 percent cutback in industrial energy use made in November 1973 and raised to 15 percent in January 1974 has had a strong direct impact on industrial production. Output in constant prices fell by somewhere between 10 percent and 18 percent from the fourth quarter of 1973 to the first quarter of 1974 (the uncertainty is due to some discrepancies in the estimate of real consumption). Since then, the economy appears to have sorted itself out rather quickly, with the wholesale price index rising at 1 percent a month rather than the 5 percent experienced at the beginning of the year. Second quarter real growth may have been as high as 11 percent at an annual rate.

Part of the reason for this swift real recovery lies in the underlying strength left over from the previous boom. In mid-1972, inventories were widely felt to be too low, and there was only a hint of developing capacity shortages. The slowdown in the winter of 1973-74 seems to have

eased these shortages sufficiently to permit some expansion.

An investment upsurge is expected, consisting partly of stockbuilding and partly of plant and equipment spending deferred from 1973.

In contrast, residential construction has a poor prognosis. Although homebuilding in Japan has tended to be pro-cyclical, a recovery will be dampened by the current high interest rates and the rise in land and construction costs.

The remarkable export boom of 1974 is unlikely to continue. True, the trade surpluses it has generated so far this year have been impressive: the unadjusted surplus of \$680 million in August occurred after an oil price rise which lifted the annual oil-import bill from \$6 billion to \$20 billion. However, much of the good performance of exports has been attributed to an essentially temporary phenomenon: Japan's capacity to fill backlogs of capital-goods orders from developing countries, which were rationed out of the world market during the capital-goods boom of 1973. The concentration of Japanese exports on machinery and durable goods should nevertheless provide reliable outlets for Japanese exports during the next world capital-goods boom likely to start in mid-1975 or early 1976.

Over the medium term, Japan's export performance is crucially dependent on the price of oil and other raw materials. It is likely that its rapidly advancing steel and shipbuilding industries will be hurt most, and that its comparative advantage in exports will shift even more towards high-technology goods that have rather small material and energy requirements in their manufacture. The effect on Japan's export competitiveness would be modified considerably if substantial

exports of oil from China become available because Japan is almost \$1.50 per barrel closer to that source of supply at current ocean tanker rates than to the Persian Gulf.

Short-term prospects for inflation in Japan continue to be rather poor. The adverse effect on real incomes from the initial rise in oil and raw material prices was rather large, so that it will take correspondingly longer for the impact on wage claims and product prices to work through the economy. While consumer prices have risen 25 percent this year, minimum contractual wages have risen 32 percent and the wholesale price index is up 35 percent. Next year's spring wage-push will probably be rather a large one and, as in other OECD countries, the expectations of continuing inflation and the impact of the initial rise on real incomes will ensure that wage inflation persists for several years.

The Japanese government expects a kind of "recession" in 1975, meaning 5 percent rather than 10 percent real growth. If this were to occur, it would have important implications for the structure of employment. Not only is it customary in Japan for employment to be a lifetime contract, but Japanese manufacturers going out of business also spend considerable amounts of time, energy and money to ensure the welfare and future job security of their former employees. This kind of paternalism can probably be sustained only if the economy is growing fast, which minimizes the extent of unemployment. At lower growth rates and increased level of unemployment, Japan's labor force may no longer be hardworking and docile, and its changing attitude would further damage Japan's growth potential and export competitiveness.

Table VII

JAPAN: CRUDE OIL IMPORTS

Thousand kilolitres^{a)}

	Fiscal year 1973 b)	Percentage shares FY 1973
Source of supply:		
Iran	89,508	30.9
Saudi Arabia	57,397	19.9
Abu Dhabi	29,242	10.1
Kuwait	23,268	8.1
"Neutral Zone"	15,406	5.3
Oman	5,365	1.9
Dubai	2,028	0.7
Iraq	902	0.3
Qatar	216	0.1
Bahrain	39	---
	<hr/>	<hr/>
Middle East	223,371	77.3
Indonesia	43,868	15.2
Brunei	9,915	3.4
China	1,639	0.6
USSR	1,423	0.5
Australia	200	0.1
	<hr/>	<hr/>
Far East	57,045	19.8
Nigeria	5,350	1.9
Libya	1,484	0.5
Cabinda	958	0.3
Algeria	67	---
	<hr/>	<hr/>
Africa	7,859	2.7
Venezuela	553	0.2
USA	78	---
	<hr/>	<hr/>
W. Hemisphere	631	0.2
	<hr/>	<hr/>
Total	288,906	100.0

a) One kilolitre (cubic metre) is equivalent to nearly 6.3 barrels.

b) April 1973--March 1974 (inclusive)

Source: Petroleum Economist, August 1974

Table VIII

INDUSTRIAL DISTRIBUTION OF JAPANESE IMPORTS

(Nominal, CIF, \$ million, %)

	1960	1970
Agriculture, forestry, & fisheries	1,647(36.7)	4,950(26.2)
Mining, inc. crude oil	1,099(24.5)	6,055(32.1)
Manufacturing	1,747(38.9)	7,779(41.2)
Foods	265(5.9)	1,106(5.9)
Textiles	18(0.4)	224(1.2)
Pulp & paper	31(0.7)	206(1.1)
Chemicals	302(6.8)	1,037(5.5)
Petroleum & coal products	135(3.0)	550(2.9)
Ceramics, stone & clay products	7(0.2)	41(0.2)
Primary metals	496(11.1)	1,645(8.7)
Metal products	11(0.3)	71(0.4)
Industrial machinery, except electrical	282(6.3)	1,262(6.7)
Electrical machinery	34(0.8)	478(2.5)
Transportation equipment	87(2.0)	406(2.2)
Precision machinery	40(0.9)	197(1.0)
Other	24(0.6)	566(3.0)
Re-export, supplies for machinery, classification unknown	<u>10(0.3)</u>	<u>91(0.5)</u>
Total	4,491(100.0)	18,881(100.0)
Agriculture, forestry, fishery and foods	1,912(42.6)	6,056(32.1)
Mining (inc. petroleum & coal products)	1,234(27.5)	6,605(35.0)
Light industries	80(1.8)	1,037(5.5)
Heavy & chemical ind. (Machinery)	1,252(27.9) 443(9.9)	5,096(27.0) 2,343(12.4)

Sources: OECD trade statistics and Finance Ministry trade statistics, as cited in A Long Term Outlook of Japanese and U.S. Economies - 1980, (Tokyo: Japan Economic Research Center, 1973).

Table IX

JAPAN

<u>Output</u>													
Trillion yen		70				71				72			
1965 prices		73				74				75			
		1				2				3			
		4				1				2			
		3				4				1			
		76				77				78			
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		4				1				2			
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France

France managed to avoid much of the immediate impact of the oil crisis largely owing to its strongly pro-Arab policy. So far in 1974, the economy has continued to be overheated, resulting in capacity shortages and one of the few excess-demand inflations that still persists among OECD countries. France has a record deficit on the trade account arising not only from the increased cost of oil but also from large imports of capital goods and consumer manufactures.

The bottlenecks are to be found in consumer goods and intermediates, with the strong demand in these sectors stemming from the increase of wages that, despite some rise in the savings rate, has gone mainly into household-goods consumption. The Giscardian policy of reducing effective demand for investment by cutting investment tax credits and tightening monetary policy (interest rates are higher than anywhere in Europe except Italy) is presumably aimed at reducing capital-goods imports rather than at lowering domestic inflation, and it may have a counterproductive effect.

Until recently, the French government's macro management measures appeared to be weak and the prospects for improvement in the oil-dominated balance of trade seemed poor. However, a payments ceiling on oil imports was recently announced that, if made effective, would reduce petroleum imports in 1975 by 10 percent and would impose a unit elasticity on oil import demand. This would, therefore, be an extremely stringent measure and some doubt must in consequence be expressed that it can be

carried through without major disruptions of industrial production. As implied in Chapter II, the existing government does not have so firm a grasp on power that it can enforce very stringent reductions in consumers' use of energy, while the alternative of limiting industrial uses is equally unpalatable because it would increase unemployment. However, even if it were relaxed in practice, this measure has a considerable shock value both to French domestic users of energy and to oil suppliers, and it might perhaps best be interpreted in that light.

The French technocrats who first introduced the value-added tax are now proposing -- and will probably succeed in getting adopted -- a progressive value-added tax as a counterinflationary measure. In its pure form, this tax has some very useful features: it creates incentives for firms both to resist wage demands and to reduce unit profits by increasing the volume of sales and lowering prices. In the process, it tends to increase real incomes and to put pressure on capacity, thus stimulating investment. However, because of the administrative problems that would be involved, the pure tax has some perverse incentives that would induce firms, if they perceive their interest correctly, not only to encourage suppliers of materials to raise prices but also to shift their own product mix towards goods with a lower labor intensity. Avoiding these perverse results would presumably require a mass of regulations and a great deal of detailed investigation of particular firms. So, it would probably be adopted in modified form and would not have as dramatic an influence on inflation or wage demands.

The outlook for the French trade deficit depends crucially on its macroeconomic-management measures and on the course of economic growth in Germany, France's major trading partner. There is a reasonable prospect that demand management might be sufficiently effective and the German economy sufficiently reflatd to improve France's trade balance at the same time as oil payments are limited. Indeed, if all goes well, it is possible that, by late-1975, France could even have a surplus in the trade balance. Meantime, France has been doing exceptionally well at getting its payments deficit financed either through the Euro-dollar market or directly by the OPEC countries. Thus, all other things being equal, there is at least a 50-50 chance that France can get through the economic difficulties of the next year or two without either the severely restrictive domestic policies or a serious recession that could provoke the political difficulties discussed in Chapter II or the need to seek extraordinary financial assistance from the United States and other OECD countries.

The medium-term prospects for expansion are less clear. Like the United States, France will have a slightly lower rate of growth of the labor force, which will tend to lower the rate of GNP growth. In addition, the oil price rise and ceiling on imports, if maintained, will slow France's expansion over the remainder of the 1970s because oil provides 2/3 of all its energy resources, only 1/3 of which is for final consumption. Hence, a considerable expansion in the domestic coal industry could be expected, as well as acceleration of the nuclear power program to which France is committed. These developments will

Table X

FRANCE

	1972	1973	1973	1974				1975	1976
			Q4	1	2	3	4		
<u>Output</u> Index of Industrial Production 1963=100	167.6	174.9	188.0	192.4	189.5	191.8	194.7	196.4	204.2
<u>Prices</u> Hourly earnings 1963=100	213.0	246.0	260.0	271.8	290.0	307.0	322.0	354.0	410.0
Consumers Price Index 1963=100	146.4	157.1	163.0	169.7	176.4	181.4	186.4	195.5	219.5
<u>Employment</u> Unemployed (Ratio)	2.30	1.56	1.68	1.94	1.73	2.23	2.54	2.77	1.87
Vacancies									
<u>Trade</u> Trade Balance, FOB-CIF \$billion current	-.49	-.53	-1.08	-5.1	-4.5	-3.3	-2.6	-.05	3.2

tend to add to the volume of governmental and private investment but they may not be rapid enough to forestall energy shortages at the industrial level. If so, this will be an additional factor making for a slower average rate of economic growth during the second half of the 1970s compared with the first half. Thus, as explained in Chapter 11, a lagging growth rate during the later years of the 1970s could have serious political consequences for the parliamentary election scheduled for 1978.

United Kingdom

Industrial output was heavily damaged at the beginning of this year, when the curtailment of OPEC oil shipments to the United Kingdom and the coal miners' strike forced the imposition of a three-day work week in much of British industry. Then, in June, the economy started to turn down again.

As in other OECD countries, the problem in Britain is that a large inflationary backlog was built up over the 1971-73 period, when the British economy managed to grow at a rate of slightly over 3 percent, with much of the increase concentrated at the end of 1972 and the beginning of 1973 (the first quarter of 1973 saw a growth in GDP of 20.8 percent at an annual rate, quarter-on-quarter). The balance of payments began to suffer at the beginning of 1973, and the underlying, nonpetroleum deficit contributed considerably to the full-year deficit in 1973 of £ 1,286 million.

The reasons for the current downturn are almost all on the demand side. Real disposable income was badly hurt during the winter of 1973-74 and did

not recover as fast as output because of the oil price rise. Demand for durables is down in addition because of stiff retail credit terms, and the fact that incomes fell at the same time that prices started to rise fast has prevented the usual anticipatory buying. Capital spending is currently being held down by a lack of corporate liquidity, due partly to strict limitations on the amount of cost pass-through permitted and partly to the high interest rates. Uncertainty over the prospects for nationalization by the Labour Party government also delayed spending in recent months.

Construction has been falling off steadily since the beginning of last year. As in other OECD countries, this industry has been caught between steeply rising materials and land costs and a falling demand due to slow growth of real income and very high interest rates.

The outlook for lower inflation in the United Kingdom is extremely poor. The chances of rapid expansion of real output are small, so that the trade unions will continue to vie with one another in an effort to increase the real earnings of their members at the expense of other groups in the society. This attitude is certainly understandable, given the absolute decline in real income over the past year and the fact that the British economy is faced with the very difficult choice of which groups will eventually have to suffer the real loss of purchasing power associated with the oil price rise. The Labour Party government is seeking to soften the impact of inflation on the poorest segments of the population by means of subsidies aimed at holding down the price of staple foods; this year's budgeted subsidies of £325 million for milk, £54 million for bread and £15 million for tea, among others, add up to a full 1 percent

of total government expenditures. However, the range of goods covered is very narrow, and the net effect of these subsidies does not improve very much the real income of the average worker, who will undoubtedly seek nominal wage gains in an attempt to reach once more the real income levels of early 1973. According to a Department of Employment study, a continuation of current trends in wage demands and industrial action could lead to a 30 percent annual rate of inflation. Moreover, even with very little union action, the fact that three fifths of all British workers are now covered by some form of wage indexing means that the momentum imparted to inflation by wages is likely to be substantial unless it is suppressed or offset by other government measures.

Fiscal policy will be mildly expansionary in an effort to stave off the widely forecast recession for the rest of 1974 and 1975. The recent reduction of the value-added tax was a step in this direction that will have the additional effect of slowing the rate of price increases. This and other measures will add £200 million to demand, while taking 2 1/2 percent off prices over the next year; however, a good deal of this price effect has already shown up in the almost zero rate of inflation in August, and cannot be expected to yield substantial further benefits. To counter-balance this expansion, it is plausible to suppose, as does The Economist (October 19, 1974), that explicit wage controls will again be imposed, thus helping to control the rise in wage costs.

The government will be constrained in its budgetary expansion by having to keep one eye on the balance of payments and the other on investment, which is currently being financed to a larger degree than usual out of borrowing. The outlook for future capital spending is

confused. A survey by the Confederation of British Industries shows a steep fall in expenditure plans (from a 14 percent to a 5 percent increase over 1973); In contrast, the Engineering Employers' Federation survey suggests considerably more bullishness, reflecting as much a desire to substitute capital for skilled workers as a forecasted need for greater capacity. Investment expenditures will probably not show a great advance in 1975 since companies are feeling uncomfortable about their heavy long-term borrowing. Thus, until equity capital becomes more easily available, long-term investment spending will be held down. However, the nationalized industries will be getting an injection of £500 million from Iran. The stockbuilding which occurred earlier this year appears to have come to an end.

Something will have to be done about homebuilding in 1975 if only to provide a reasonable increase in the supply of housing. Some improvement can therefore be expected in expenditure on the housing industry, most probably through some kind of mortgage-finance arrangement. Domestic consumer spending is unlikely to lead an expansion since the savings rate is already low and spending is constrained by the decline in real income.

In contrast to exports from Germany and Japan, those from the United Kingdom are doing badly. The terms of trade improved by 45 percent (annual rate) in August, leaving them only 9.9 percent worse than a year ago, which implies that Britain's export prices have risen almost as much as its import prices and that, as a result, the volume of exports is declining. In a pre-election forecast, the Chancellor of the Exchequer projected the disappearance of the current non-oil

trade deficit of £ 440 million by the end of 1975. Until the summer, the non-oil deficit was decreasing, but it ran £20 million higher in September than in August. Prospects for increases in exports in the next year or so are limited by Britain's capacity problems, inflation rate, perennial reluctance of its manufacturers to take export risks, and the slow growth in world demand expected in 1975. Little can be done on the import side, since imports are vital to the British economy -- supplying, for example, 25 percent of consumption -- and are notoriously price-inelastic.

The payments deficit is currently being financed by oil money, either placed directly in London or borrowed through the Eurodollar market. The Iranian investment in the nationalized industries has already been noted, and there is considerable scope for OPEC funds to go into direct equity participations -- as a London consultant points out, the current market value of Britain's top 1,000 companies is somewhat less than one year's OPEC surplus.

The medium-term prospects of the British economy are dominated by three factors: the balance of payments, North Sea oil, and inflation. The anticipated bright spot -- the receipts from North Sea oil -- may well be beclouded if the calculations of the London Business School prove correct that the cumulative deficit on the oil account between now and 1978, when the oil will start to flow in quantity, could not be paid off with the payments surplus expected thereafter. Nor does this conclusion take into account the probability of a continuing substantial non-oil deficit. Devaluation -- which has been used as a way out of similar difficulties in the past -- may be tried again but would be of limited help to the extent that the external debt contracted to pay for oil imports would not be denominated

in sterling, and because the terms-of-trade effect of devaluation has tended to be uncertain. To achieve a surplus on non-oil account, therefore, the government may be compelled to institute price and wage controls sufficiently stringent to bring about the requisite distribution of income and thus to contain the domestic component of inflation. The alternative -- that Britain would be forced into a severe and long-continued recession for balance-of-payments reasons -- is likely to be avoided by any British government at almost any cost.

As in other OECD countries, Britain will have to make changes over the next decade in its industrial structure to accommodate to a higher energy price. Table XI presents the investment plans of British firms as shown in a recent study of the National Economic Development Office. Although much smaller than the estimates of investment expenditures given earlier in Table IV, the figures are nevertheless large and as suggested above, a good deal of the 1974 requirement is not likely to be met. Unlike the United States, Britain will feel capital constraints over the next decade: in order to attract foreign loans to cover the balance-of-payments deficit, it will probably have to channel them into the highest-yielding, lowest-risk sectors, thus displacing domestic funds. Therefore, to the extent to which OPEC funds and other sources of financing are not available, the United States should be prepared to make loans to the United Kingdom on favorable terms to cover part of the temporary oil deficit without putting pressure on the U.K.'s domestic capital markets. Britain's peculiar circumstances, which permit almost no freedom of action on the part of the government, are sufficient to warrant the assumption that a considerable portion of the default risk may have to be borne by the United States.

UK Investment Anticipations for Process Plant

£ million

	ACTUAL		PLANS (LATE 1973 PRICES)				
	1973	1974	1975	1976	1977	1978	
Chemicals	129	172	184	178	N/A	N/A	
Oil							
Exploration and production	110	180-220	160-228	136-212	112-207	63-130 ^a	
Refining ^b	17	52-65	69-92	61-87	31-47	23-36	
Distribution	15	10-11	7-9	5-8	5-8	5-8	
Gas ^c	44	82	79	74	59	46	
Electricity	89	86	84	85	97 ^d	115 ^d	
Total	402	582-636	583-676	539-644	N/A	N/A	
Total (excluding chemicals)	275	410-464	399-492	361-466	304-418	252-335	

^aThis could be a substantial underestimate if there are further oil finds on the Continental Shelf

^bOil industry forecasts have tended to exaggerate the extent of rises and falls compared with what actually transpires

^cPast gas forecasts have tended to be optimistic, but the above figures make no allowance for possible expenditure on gas associated with North Sea oil discoveries and therefore probably substantially underestimate likely demand, particularly in later years of the forecast period

^dFigures could vary substantially from those quoted depending on forecasts of future electricity demand and decisions on nuclear reactors

Source: The Increased Cost of Energy - Implications for U.K. Industry, (London: National Economic Development Office, 1974), Table 5.1, p. 42.

Table XII

UNITED KINGDOM

[illegible]

Italy

In real terms, Italy managed to do rather well during the first quarter of 1974. Like many other OECD countries, it enjoyed unusually good growth in 1972-1973 following strikes and shortage of inventories in the engineering and metallurgical industries in the preceding years. During the boom period, domestic demand, investment and employment were all high. The resulting high rate of capacity utilization undoubtedly contributed to the much poorer performance on the inflation front, which was exacerbated by import price rises. Also, the balance of trade worsened steadily over the period owing to the relative price-inelasticity of Italy's imports, a high proportion of which is raw materials and fuels.

During the first half of 1974, the balance of trade went seriously into deficit. At the same time, some domestic price restrictions were lifted, with the result that inflation reached very high levels. Consequently, at mid-year, austerity measures were introduced to cope with domestic demand. Like France and unlike the other OECD countries examined here, Italy has been suffering from a genuine excess-demand inflation as well as an imported one -- so the short-term policy imperatives have been relatively clear for Italy. At mid-year, the economy was running an inflation rate of about 24 percent, quarter-on-quarter at annual rates. Much of this will be built into price expectations and wage contracts for the next several years. Hence, Italy can be expected to suffer from continuing cost-push inflation, perhaps of the order of 15 percent in 1975.

The stringency of the Italian government's austerity program will depend on the state of its external balance, and hence on the amount of outside help available.

The austerity program announced in June 1974 will, if effectively implemented, reduce Italy's national income by an estimated 5 percent. To this should be added the reduction of approximately 3 percent in domestic expenditure resulting from the oil price rise. The deflationary effect of this combination would be quite drastic, and would lead to either zero or negative domestic growth in demand over the rest of 1974 and in 1975. However, Italy can look forward to further growth in steel exports, which will tend to reduce the trade deficit while at the same time providing a source of demand.

For the medium term, Italy -- like Japan -- will find itself constrained by its import pattern. It has rather few domestic resources, with the majority of its raw materials coming from abroad, and with most of its energy requirements having to be imported. As other countries with more favorable resource endowments adjust to the higher energy price, Italy's comparative advantage in many of its usual exports will be eroded. Until now, and for the next year or so, this effect can be partially balanced by progressive depreciation of the lira, but this form of relief cannot continue for long when so much of the raw materials for its manufactured exports are imported. Over the medium run, therefore, Italy is either going to have to find some way of reducing the growth

in domestic labor costs or it will have to accept a lower rate of growth of real income. Either of these possibilities will generate serious political difficulties as explained in Chapter II.

Table XIII

ITALY

	1973	1973 Q4	1974				1975	1976
			1	2	3	4		
<u>Output</u>								
Industrial Production Index 1963=100	165.8	171.0	176.1	173.8	171.0	170.0	177.0	184.0
Capacity utilization (%)	90.0	91.0	93.0	91.0	89.0	88.0	90.0	90.0
<u>Prices</u>								
United labor costs (Ratio)	151.4	156.2	162.5	178.1	196.9	208.2	229.9	273.0
Wages (minimum contract) 1963=100	251.0	267.1	286.2	309.5	336.8	356.1	393.2	471.8
Consumer Price Index 1963=100	157.3	163.2	172.1	181.3	191.5	197.9	216.0	246.9
<u>Employment</u>								
No. Unemployed (C'70)	672.0	592.0	530.5	551.1	579.6	618.0	757.0	850.0
<u>Trade</u>								
Exports (\$ billion)	22.17	25.23	26.54	29.13	29.81	30.94	34.5	41.6
Imports (\$ billion)	27.79	31.06	40.12	43.47	42.01	42.0	42.75	46.0
Trade balance FOB-CIF \$ billion current	-5.62	-5.84	-13.58	-14.34	-12.19	-11.06	-8.25	-4.33